BROADENING THE TAX BASE IN KENYA:

The case of the informal sector

(A diagnosis of the current practice & a prognosis of reform options)

August 2014

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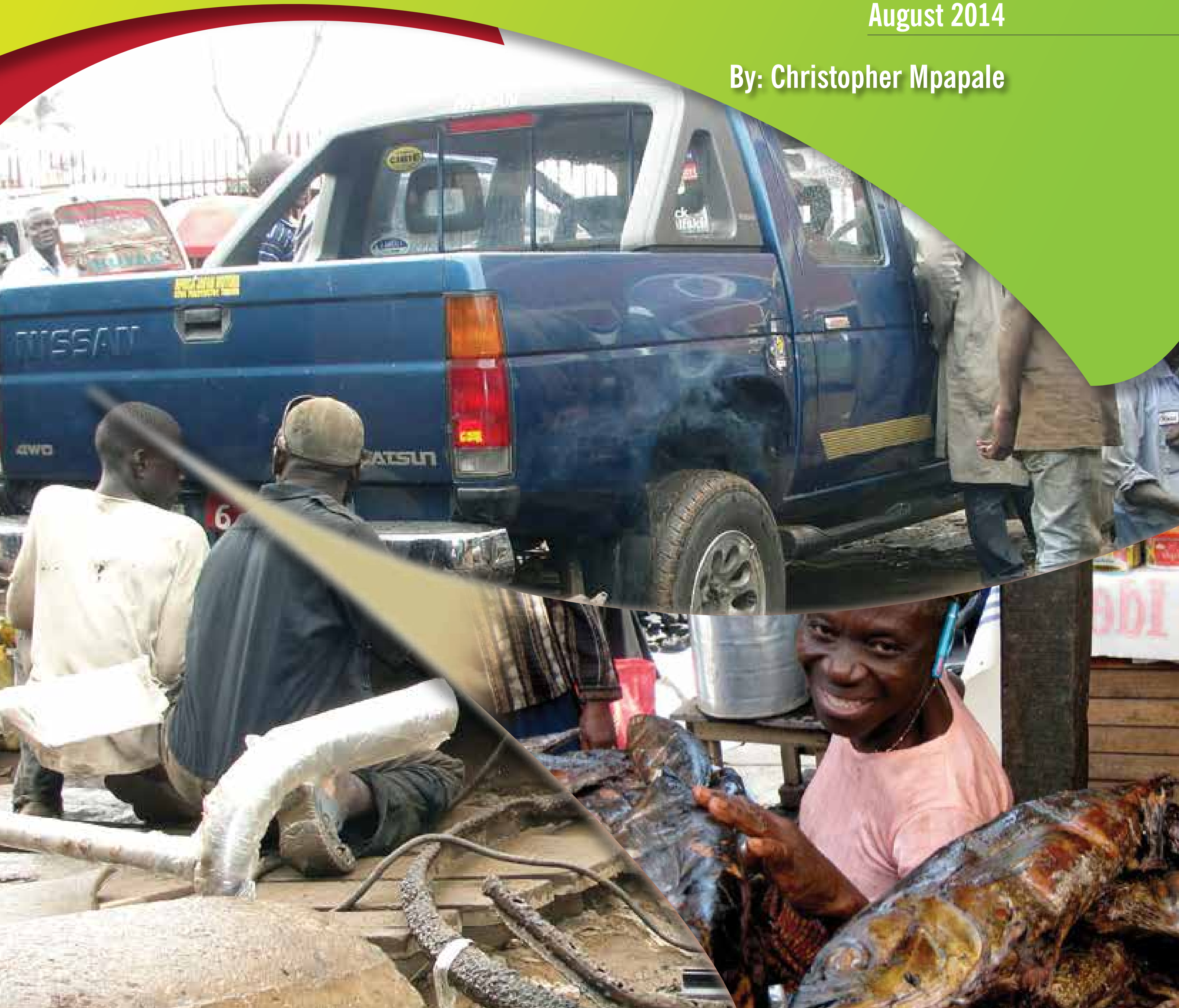

Fact Sheet

OVERVIEW

The East Africa Tax and Governance Network (EATGN) was formed out of a process that began in late 2009 and has since expanded to include 26 member organizations. Its members are individuals and non-state actors institutions involved with the different aspects of governance, capacity development and policy making process as well as applied social research in East Africa.

MISSION

To establish a vibrant tax justice movement across the Eastern Africa region that mobilizes citizen participation in influencing policy and practice for a just and equitable society.

OBJECTIVES

To contribute to a just, transparent and citizen-driven tax system that promotes equality, participation and accountability in East Africa.
We operate under the following specific thematic areas:

1. Research- we conduct research in order to generate knowledge and inform tax policy and legislation while promoting a just and transparent tax system
2. Advocacy – We advocate for a just, transparent and accountable tax system in East Africa
3. Communication – We seek to enhance internal and external EATGN communication to strengthen the network and bring about a more just tax system
4. Networking – We are always seeking to be all inclusive through strengthening and expanding the network reach
5. Capacity building – We seek to always build our own capacity and that of the citizens, media, policy makers and other Stakeholders to better participate in tax and governance issues.

OUR VALUES

- Diversity - Our differences strengthen us,
- Passion and Commitment – Our members are committed to the work that we do and we seek to positively impact East Africa,
- Professionalism - We value excellence, work systematically, set and keep high performance standards. Accountability: we are guided by accountability in our work and in achieving results within our spheres of control,
- Transparency and openness – we expand our knowledge base by being open and allowing decisions and the status quo to be challenged.
- Sensitivity - we believe that there is more than one way to look at the world and that the diversity of views, experiences, skills, capabilities and beliefs enrich work,
- Participation and Inclusiveness – we seek to improve the quality of decisions by actively involving people in the decision-making process,
- Resourcefulness - we always strive to do more with less.

PARTNERS

- Africa Community Development Media (ACDM)
- Africa Bureau of Tax Policy and Law
- Panos Eastern Africa
- Christian Aid
- Centre for Governance and Development/ National Taxpayers Association
- Citizen's Assembly / Ufadhili
- Beacon
- CGIT Center for Governance and Integrated Trade
- Society for International Development (SID)
- Kenya Debt Relief Network (KENDREN),
- International Institute for Legislative Affairs Kenya
- Institute for Economic Affairs Kenya (IEA)
- Transparency International Kenya (TI)
- Tax Justice Network–Africa (TJN-A)
- Action Aid International Kenya
- SEATINI Kenya
- Neema Charity Foundation (NEMCHA)
- Taita Resource Center
- Burundi Forum Societe Civile
- ADIR Burundi
- Rwanda Civil Society Platform
- SEATINI Uganda
- Tanzania Tax Justice Coalition
- Extractives Sector Observatory Kenya
- Ujamaa Center
- Civil Society Budget Advocacy Group Uganda

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Acronyms and Abbreviations

BOP	Balance of Payments
DRC	(The) Democratic Republic of Congo
EABL	East African Breweries Limited
EPZ	Export Processing Zone
GDP	Gross Domestic Product
IEA	Institute of Economic Affairs
IMF	International Monetary Fund
IPO	Initial Public Offer
ITA	Income Tax Act
Jua Kali	(Swahili for “Blazing Sun” in the context of informal business establishments/ premises usually associated with the informal sector)
KCB	Kenya Commercial Bank
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
KShs.	Kenya Shillings
Mitumba	“Swahili for second hand” in the context of the apparels, clothes and textiles industry in Kenya.
MNCs	Multi-National Corporations
NBAA (T)	National Board of Accountants and Auditors of Tanzania
NSE	Nairobi Securities Exchange
PAYE	Pay As You Earn
PIN	Personal Identification Number
SME	Small and Medium Enterprises
TOT	Turnover tax
TP	Transfer Pricing
TRA	Tanzania Revenue Authority
TSC	Teachers Service Commission
TShs.	Tanzania Shillings
UShs.	Uganda Shillings
VAT	Value Added Tax
WHT	Withholding tax

Abstract

Kenya recorded an annual GDP of KShs. 1.68 Trillion in 2013 according to statistics provided by the Kenya National Bureau of Statistics (KNBS) in its annual publication of the *Kenya Facts & Figures Report, 2014.* The annual GDP for 2012 stood at KShs. 1.61 Trillion as per the same report. By comparison, East African countries have witnessed a marginal increase in their annual GDPs over the past three years from 2011 to 2013 with Tanzania recording TShs. 44.7 Trillion & TShs. 53.1 Trillion in 2012 and 2013 respectively *(Statistical Abstract 2013; Tanzania National Bureau of Statistics).* On the other hand, the *Ugandan 2013 Statistical Abstract* published by the Uganda Bureau of Statistics puts the country's annual GDP at UShs. 45 Trillion in the year 2011 and UShs. 53 Trillion in 2012.

Despite the above trend, these countries have consistently recorded revenue deficits in their National Budgets. This has made it increasingly difficult for them to finance state expenditure on both capital and recurrent platforms.

According to ***Fjeldstad (2003),*** majority of nations in Sub Saharan Africa face these trilemma with regard to state taxation and domestic resource mobilization:

a) The crucial need to generate more revenues to provide and sustain the basic infrastructure and social fabric;

b) The challenges resulting from a narrow tax base which depends on a few taxpayers for all their revenue collections;

c) Defective, inefficient and porous tax administration regimes that have consistently failed to reduce revenue leakages through tax evasion and tax avoidance by both large and small scale sector players.

In Kenya, there has been a deliberate attempt by the National Treasury and the Kenya Revenue Authority (KRA) to reform the tax system and make it more responsive and efficient to emerging trends such as revenue loss through carefully crafted Transfer Pricing (TP) policies by corporations *(The Business Daily Newspaper, 21 August 2014).*

However despite these changes, the Kenyan tax regime is still struggling very much so in particular sectors due to the inadequacies of the current structure to efficiently tax certain industries and sectors of the economy. A classic example of this ineffectiveness is seen in the failure by the KRA to contain with precision the (TP) activities of Multinationals and local subsidiaries of companies in the Flower and Horticulture industry.

This paper attempts to analyze the current taxation framework in Kenya in terms of the effectiveness of its revenue collection strategies towards the informal sector. It defines and describes the informal sector and its contribution to the economy as well as the general types of taxes enforced by the commissioner to the larger economy, and their specific impact to the sector.

On a case by case basis, the paper narrows down to unpack the legal framework and evaluate how effective the tax administrator is in bringing the players in the informal sector into the tax bracket.

The paper finally makes insightful policy recommendations on the necessary technological, administrative and legislative reform options available to enhance revenue collections in the informal sector. These recommendations, having been tried and tested in other tax jurisdiction in America, Europe and South East Asia with remarkable success will go a long way in enhancing revenue collections, widening the tax base and ultimately contributing to tax justice once implemented.

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1. The informal sector in Kenya

Defining the informal sector

In Kenya, the informal economy is commonly referred to as "Jua Kali", a name coined in the early nineties by entrepreneurs because of the characteristic nature of the sector's activities being conducted under the blazing sun. Informal sector activities are mainly concerned with the production, manufacturing, distribution and sale of household, farming & industrial items.

The "Jua Kali" definition includes petty traders, street vendors and other roadside service providers whose trading activities further assist to describe the sector by nature. Business establishments under the informal sector are characterized by operating as sole proprietors with minimal employees if any; the absence of a formal organizational and administrative structure, non-declaration of formal taxes, modest or very low use of technology, low annual turnover and mostly without a fixed place of business.

The informal sector generally operates in the most modest of circumstances usually on a small scale basis without caution to environmental or tax regulations and making use of simple skills. *(Ouma et al, 2007).*

Typically, the sector comprises economic activities not regulated by laws such as environmental, labor or taxation, but is subject to the regulations of the local authorities for orderly business operation, and generally not monitored for inclusion in the GDP of Nations.

1.1 How big is the informal sector?

The informal sector activities by nature operate under a fairly loose administrative and legal framework in comparison to the activities of the formal sector. Since the government has not put in an effective administrative framework to govern the operations of the sector as later discussed in this paper, its contribution to the GDP has often been overlooked.

In Kenya, the informal sector is fairly large accounting for an estimated 25% of the national GDP *(KNBS Economic Survey, 2012).* There has been a sustained growth in the sector over the years with the initial SMEs baseline survey published in 1993 estimating that the 910,000 SMEs in the sector employ up to 2 million people. According to official data contained in the Economic Survey for the year 2010, the informal economy in Kenya employed an estimated 8.3 Million people with an approximate 75% of the nation's labor force being in the non-agricultural private sector.

Providing the necessary economic and administrative support to the informal sector will not only increase the per capita GDP in the nation of Kenya but will also enhance the participation of women and youth in the nation's economic affairs. The informal economy has attracted an estimated workforce in excess of 60% of the working population aged between 18 and 35 years; and half of these are women as per the *IEA Budget Focus, 2011.*

1.2 Informal sector growth

One of the fundamental factors that have contributed towards the growth of the informal economy is the ease with which one can enter and leave the sector. As discussed earlier, by practice the sector is not closely and adequately regulated and businesses need not necessarily be formally registered in order to transact; the absence of such requirements has made it attractive to many citizens.

The scarcity of formal employment even after concluding formal education is also considered as one of the major push factors that have led to a majority of university and college graduates

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to resort to the informal sector. Other push factors that have contributed to the significant growth of the sector include:

- Low education levels among the population to warrant any other form of sensible employment; and
- The inability to raise sufficient initial capital to set up the formal and more complex business ventures.

2. The need for informal sector taxation

In theory, a taxpayer's incentive to comply with a tax system depends on their assessment of the relative benefits and associated costs of compliance versus non-compliance. According to a report by the Institute of Economic Affairs analyzing the Finance Bill 2011, one the profound reasons why the players in the informal sector are unwilling to remit taxes to the authorities is the general perception that the tax burden is too high. This essentially poses a significant challenge to the administering authorities to develop effective mechanisms that enhance a tax compliance attitude linked to the level of civism and patriotism of the citizens in line with the social contract between the state and citizens.

It needs to be clear from the outset that the sole objective of an efficient tax regime in the context of the informal sector is geared towards widening the tax net to factor in the contributions of the sector players to the public coffers however negligible; and not to suppress growth in the sector or disproportionately burden the poor while the rich do not pay their fair share.

Advancing legal and administrative tax reforms in the informal sector is by no means a strategy aimed at stifling growth or suffocating its very existence; on the contrary, these reforms are meant to unlock the ultimate potential of the sector and gradually transition it from informal to formal.

Perhaps by analyzing the consequences of a weak informal sector tax regime in Kenya, we will appreciate better the need to broaden the tax base and accommodate it within the current tax net. Discussed below are some of the pitfalls of not adequately taxing the informal sector:

2.1 Revenue loss

The mere fact that the informal sector thrives outside the formal regulatory framework governing tax administration and business registration poses an inherent risk of revenue loss. Indeed copious volumes of revenue leaks are brought about by the above lack of a tight regulatory mechanism to adequately seal off and prevent revenue loss from the sector.
It is incorrect to presume that there are no legislations currently taxing the informal sector in Kenya; on the contrary various attempts have been made by the government to tax the informal sector but mainly through licensing and issuance of trade permits.

It has become increasingly difficult to implement a variety of meaningful taxation strategies to players within the sector because of the imprecise and nebulous nature of the establishments operating within it.

During the early nineties, the potential taxable income accruable from the informal sector economy was on average 4% of the GDP as per IEA's Budget Focus, 2011. Empirically, this meant that the authorities had the potential of expanding the tax base by a proportion equivalent to 4% of the GDP. To put this in a more contemporary context, in the year 2013, the nation's GDP was estimated by the Kenya National Bureau of Statistics to be about KShs. 1.68 Trillion, 4% of this is KShs. 67.2 Billion. Assuming a similar proportion of contribution, this means that the tax base in the year 2013 would have been expanded by an estimated KShs. 67.2 Billion.

2.2 Undue competitive advantage over the formal sector

Both the formal and informal sector in the country produce more or less the same products and services; though not exactly identical in terms of attributes and quality, these products and services serve the same purpose and compete for the same resources and markets. Regulating the formal sector tightly with one hand while leaving the informal sector without any framework of regulation on the other disadvantages the players in the formal

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sector. The textile, clothing and apparel industry has for instance in the recent past felt the heat resulting from a red tape on one hand and free market on the other. This was occasioned by the unregulated importation of the "Mitumba" clothes into Kenya.

The resultant unfair competition from non-registered entities in the informal sector has significantly curtailed the potential in the formal sector. The fact that entities in the informal sector are not registered for VAT means that they are able to sale their products at fairly low prices as they are not obliged to load the VAT element on their output as opposed to registered entities. When such establishments operating outside the VAT regime are allowed to chase after the same customers with those operating under the VAT law:

a) The market share of the registered establishments will be lost because of obvious pricing reasons and this may force them out of business;

b) The registered establishments' sales which would have earned VAT will be greatly reduced hence denying the government revenue.

2.3 Horizontal equity

One of the hallmarks of a sound tax system is equity and fairness. The principle holds that, generally, individuals with similar ability to contribute to the public coffers should contribute the same or similar amounts. To be neutral, a tax system should not discriminate against similar individuals, give one undue advantage or unduly precipitate a distortion in behavior or conduct of individuals under the same indifference curve.

The failure of an equitable mechanism that ensures compliance from both the formal and informal sectors contravenes this principle of horizontal equity. This happens because the tax burden is shifted to the formal sector only whereas both the formal and informal sectors benefit from the service provision, social infrastructure, and related investments facilitated by the taxes collected.

The inability to tax the personal income of a self-employed person just like that of an employee in formal employment also creates inequalities between earners hence perpetuating tax injustice at the expense of horizontal equity.

3. Challenges of taxing the informal sector

3.1 Business records

The sector is characterized by the existence of non-static entities which are to a large extent intangible. The basis of computing tax liability in any accountable and transparent tax regime is the availability of accounting records without which nobody will ever tell how much is due and when it is due. Many entrepreneurs in the informal economy do not keep proper business records for several reasons:

a) They lack the requisite knowledge and skill to maintain sensible records;

b) The associated cost of maintenance of records which they find unnecessary to sustain;

c) Their deliberate attempt to avoid settling tax obligations because the capacity of KRA to chase non-compliant economic actors is too weak at the moment.

3.2 Bureaucratic business registration procedures

The sector operators who may be willing to register themselves and their business are usually discouraged by the fact that there are too many legislative and administrative bottlenecks. More often than not, the resultant delays in obtaining business licenses stems from a lack of coordination between the various government agencies involved in the registration process. There exist a number of entrepreneurs with capacities to produce quality goods and services who would potentially enter into supply contracts with the government but who have in the meantime chosen to operate informally because of such registration red tape tendencies.

3.3 Direct registration costs

The county Governments for instance are notoriously known to increase the cost of obtaining a single business permit in order to either set up a business or renew an existing license. In Nairobi County for instance, depending on the nature of the business in question, the cost of obtaining a single business permit has almost doubled between 2012 and 2014 as per the revised County Business Permit rates applicable to business operators in the city. Such arbitrary increases in business registration costs year after year have discouraged many willing players in the sector from registering their establishments.

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4. Taxation strategies in Kenya

Within the context of the informal sector, the tax base in Kenya still has an enormous potential for expansion despite the current attempts by the Treasury and KRA to seal revenue leaks.

The taxation framework in Kenya has been designed to rely on the following major tax heads:

- Corporation tax;
- Pay As You Earn;
- Withholding tax;
- Value Added tax.

We detail below a brief analysis of each of the above tax heads and evaluate the extent to which the tax heads have achieved to efficiently tax the business activities in the informal sector.

4.1 Corporation tax

This is governed by the provisions of the Income Tax Act cap 470 of the laws of Kenya. Corporation tax applies to both resident and non-resident companies. Resident companies are incorporated in Kenya whereas non-resident companies are incorporated elsewhere but derive their income from Kenya. Generally resident companies are taxed at the rate of 30% of their taxable income.

Effectiveness of Corporation tax in the informal sector

Corporation tax as a revenue collection strategy has absolutely no effect on the business activities of the informal economy. This is because the tax head has been designed to cover formal business establishments with a properly defined management and reporting structure.

Since the tax rate is applied on the adjusted taxable income of a company, it essentially requires that proper books of accounts be prepared and audited to provide the initial assurance that they in fact present a true and fair view of the financial transactions of the entity before they can be relied upon to prepare a tax computation. Such strict regulatory requirements are overlooked in the informal sector because of their requisite skill and associated costs.

4.2 Pay As You Earn

The taxation of personal emoluments of employees in Kenya from any business activity that creates an employment relationship is governed by both the provisions of the ITA and PAYE subsidiary guidelines issued by the KRA. Generally, PAYE is an agency tax system where the employer is expected to act on behalf of the government to deduct and remit to the revenue authority an amount of tax commensurate to the employee's emoluments with regard to their services to the employer.

PAYE is therefore an employee's tax since they bear both the incidence and burden of tax. However, in as much as this tax does not belong to the employer, in instances where the employer fails to comply with PAYE legislation; they suffer penalties and interest as prescribed and the principal tax recovered from them as though they were the payer.

The third schedule to the ITA outlines the tax bands (graduated scale) under whose framework tax is computed. These annual bands are as outlined below:

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Income bands	Rate in each shilling
On the first KShs.121,968	10%
On the next KShs.114,912	15%
On the next KShs.114,912	20%
On the next KShs.114,912	25%
On all income in KShs. 466,704	30%

(Source: paragraph 3, third schedule ITA cap 470 of the laws of Kenya)

Effectiveness of PAYE in the taxation of the informal sector

The KRA recognizes taxpayers by use of PIN which distinguishes the unique identity of each individual taxpayer whether human or body corporate. In order to transact any business with the KRA, an entity needs to be initially registered and issued with this PIN.

Presently, with majority of entities in the informal sector being neither registered by the KRA nor in possession of a PIN; it become increasingly difficult to efficiently tax their personal incomes. As a matter of fact, such individuals are non-existent in as far as taxation is concerned since their details appear nowhere within the KRA's taxpayers database.

The PAYE strategy therefore, has failed to bring in the players of the informal economy into the tax net to the extent that it only recognizes employees and employers in the formal sector excluding those in the informal sector because of non-registration.

The incentives conundrum and PAYE

Paragraph 1 of the third schedule to the ITA, provides for a personal relief of KShs. 13,944 per year which translates to KShs.1,162 per month. According to the graduated scale discussed above, the first monthly income of KShs 10,164 is taxed at the rate of 10%. The tax payable from this is KShs. 1,016 which is effectively swallowed up by the KShs. 1,162 relief above. Essentially, this means that if I were an employee earning a monthly salary of KShs. 10,164 or below, I would never be subject to PAYE in Kenya because of the incentive mechanism above.

For most small scale traders in the informal sector, a minimum monthly income of KShs. 10,000 or less is a norm rather than the exception, that means that even if these people were to voluntarily register with the tax authorities, it will still be meaningless because of the way in which the current PAYE legislation is structured, the incentive (relief) offered makes the PAYE strategy extremely porous to effectively zero in and tax such members in the informal sector.

4.3 Value added tax

VAT in Kenya is a consumption tax levied by registered persons on certain goods and services supplied or consumed in Kenya *(Section 5 VAT Act, 2013).*

Evolution of VAT

The VAT law has undergone significant transformation in this country having started with a sales tax regime in the mid-seventies that was replaced in the early nineties by the VAT Act cap 476. Sales tax was extremely limited in scope only covering manufactured goods; the VAT Act cap 476 expanded the scope of VAT to include services both local and imported.

However, the VAT Act cap 476 ended up being a patchy legislative piece with far too many revenue leaks occasioned by constant amendments and introduction of subsidiary legislations and legal notices over the years. This eventually led to the enactment of the VAT Act 2013 in September 2013.

From a VAT administration perspective, though not a perfect piece of legislation; the VAT Act

2013 is a more precise law and a fair attempt at simplifying the VAT regime in Kenya especially with its specific provisions in sections 30 to 33 aimed at reducing the current VAT refunds backlog (currently in excess of KShs 30 Billion). Regrettably, this simplification process has resulted into an increase in the tax burden for the general population through the taxation of various household goods.

Currently the Act provides for only two tax rates for all taxable supplies; the 16% (standard rate) or 0% (zero rate).

Effectiveness of VAT in informal sector taxation

In summary, VAT is largely ineffective as a tax mechanism in the informal sector because of the following three main factors:

a) Despite the latest attempt to simplify it, the law is still fairly complex to apply and administer especially with regard to the low literacy levels associated with the informal economy.

b) The tax mechanism is highly formal requiring that suppliers of *'vatable'* goods and services with a permanent establishment in Kenya be formally registered and issued with a certificate; this is very difficult to achieve due to the (fluid) non-static nature of players in the informal sector with no fixed place of business.

c) *Section 34 (1) (a)* of the VAT Act 2013 sets a minimum threshold of the value of taxable supplies that would trigger registration for VAT to be an average annual turnover of KShs.5 million which in all honesty is too ambitious to lock in majority of the taxpayers in the informal sector who fall way below this threshold.

4.4 Withholding tax

This is a revenue collection strategy that was specifically designed to tax the incomes of non-payroll earners and other irregular earners of income. In practice, withholding tax (WHT) is a method whereby on agency basis, the payers of certain incomes deduct tax at source from payments due to certain payees and remit the same to the KRA.

The provisions governing the operationalization of withholding tax in Kenya are contained in *section 35* of the ITA as well as the third schedule to the ITA.

Effectiveness in the informal sector

As discussed above, WHT is an agency tax whereby the payers of certain incomes act on behalf of the KRA to deduct the same at prescribed rates and remit to the government. In order to act as an agent of the KRA, one has to be a registered business entity or individual. Whereas many of the establishments in the informal sector ordinarily receive services that are subject to withholding tax, they are not able to deduct this and remit because of the fact that they are not registered.

Paragraph 3 (g) of the third schedule to the ITA for instance prescribes that WHT at the rate of 20% shall apply to all non-resident persons in respect of appearance at or performance in a place whether public or private for the purpose of entertaining, instructing or participation in a sporting event.

For many local entertainment joints in the estates and urban centers around the country, the government is losing a lot of revenue to musicians and dance troupes from neighboring countries like Tanzania and the DRC who perform almost daily from Wednesdays to Sundays earning stage performance fees that are ideally subject to WHT as per above legislation. Because most of these local entertainment spots are not registered, they do not account for WHT as required by law.

Paragraph 5 (f) (i) and (ii) of the third schedule to the ITA seeks to tax management, contractual, professional and training fees receivable by resident persons deemed to be offering any technical, professional, consultancy or agency services in Kenya. However, the aggregate threshold set for these is KShs. 24,000. This means that for the provision of such services whose aggregate value falls below KShs. 24,000, no tax shall be paid. The presence of such provisions within the WHT legislation makes it very difficult to tax the qualifying services offered by the players in the informal sector whose income per transaction is way below that threshold.

4.5 Turnover tax

Turnover tax (TOT) was introduced by the Finance Act 2006 through a provision in the Income Tax Act cap 470 under *section 12(c)* as read together with *section 34*.

TOT is perhaps the best attempt so far by the tax legislation in Kenya to bring to charge the incomes of businesses in the informal sector. TOT is applicable to any resident person whose turnover from business exceeds KShs. 500,000 but does not exceed KShs. 5 Million during any year of income.

For purposes of *section 2* of the ITA a business includes any trade, profession or vocation and every manufacture, adventure and concern in the nature of trade excluding employment. By the above definition therefore, virtually all activities of the informal economy constitute business and are thus subject to tax. The applicable rate of tax for TOT is 3% charged on the gross annual sales of an entity. No expenditure or capital allowance is granted against turnover tax and for income tax purposes, TOT is a final tax.

Registration

Essentially, all taxpayers whose gross sales from their business activities are less than KShs. 5 Million but exceed KShs, 500,000 are legally required to register their businesses for TOT. For the sake of TOT, "persons" includes partnerships and sole traders alike.

Record keeping

The extent of record keeping required under the TOT regime is much simplified in comparison to other tax heads, the amount of turnover tax for a given year is payable quarterly on or before the 20th day of the month immediately following the end of the quarter. The ideal records required under TOT are as follows:

- Annual Cash books;
- Annual sales receipts and invoices;
- Daily sales summaries;
- Bank statements.

The key benefits of turnover tax that make it the most effective tool for broadening the tax base in the informal sector are as summarized below:

- The TOT approach presents a much more simplified tax procedure;
- The provision to disallow any form of expenditure including that of a capital nature ensures a simplified tax computation based only on turnover (sales);
- TOT requires a simplified record keeping approach (single entry accounting);
- Compared to the other tax heads, TOT presents an approach which will incur the least administrative cost of compliance by among other things making returns filing easier.

5. Proposed tax reform options in the informal sector

Already alluded to in the above discourse is the policy direction of moving to broad bases in the taxation of individuals and companies; both in the formal and informal economies.

There is no research that suggests this is not suitable for a developing economy like Kenya.

Many developing economies have very narrow tax bases with large number of incentives and tax exemptions many of which have been carefully designed to protect the interests of the better leveraged actors within the socio-political and economic landscape. *(H. Christopher, 2001).*

In Kenya, a base broadening strategy will have the advantage of raising revenue, improving the economic efficiency and achieving an even greater redistribution of wealth. The specific question we need to answer is: how can we effectively tax the informal sector?

A number of reform options need to be carefully considered to effectively broaden the tax base and effectively cover the sector.

5.1 Technological reform options

Arguably, even with the current skewed legislations affecting tax practice in Kenya, a deliberate attempt to embrace technology will significantly improve revenue collections and expand the tax net. As already pointed out above, the architects of turnover tax had the informal economy in mind. Notwithstanding its inadequacies, the TOT legislation is largely appropriate. The problem is the lack of a technologically savvy implementation mechanism that ensures compliance with minimum administrative burdens.

Below are some proposals that if implemented will greatly enhance not only TOT but other tax heads as well:

5.2 A cashless economy

For this nation to achieve efficiency in revenue collection there is need to automate more. A lot of revenue leaks occur as a result of the economy relying heavily on cash based transactions. In the informal economy for instance, accuracy and integrity in record keeping is at the whims of the taxpayer, there is absolutely no proper mechanism available to the taxman to vouch or dispute the sales records of a “Jua Kali” artisan for instance and ascertain the accuracy thereof. Very little is being done to mitigate against fraudulent cases of deliberately understating turnover since with manual records anything can happen at the taxman’s peril.

5.3 Credit cards

The inherent risk of traders overstating their allowable business expenditure resulting in an understatement of their taxable profits could be adequately covered through the use of credit cards. If for instance, a significant portion of the daily transactions in the economy are cashless, the taxman need not rely on the taxpayer for manual purchase invoices that will most likely be forged. All they need to do is obtain their expenditure record from an independent third party (MasterCard, Visa etc.) and this will form an appropriate basis of ascertaining the actual expenditure incurred.

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5.4 Automation of the revenue collection system

This is currently underway on the *i-tax* platform and this is laudable despite the initial teething problems and system failure witnessed in the month of March 2014. The KRA is losing volumes of revenue because of its manual system of receiving payments and processing returns. It is very difficult for instance to ascertain the accuracy of the returns filed for PAYE, VAT, WHT and Corporation tax for all taxpayers in their data base every month.

It is even a challenge to provide space to file all these returns in the first place let alone to retrieve and review those returns filed in the prior years.

With the current manual system, tax cheats get away with it and the commissioner will least likely ever establish their intelligently weaved tax evasion schemes executed through understatement of their tax liabilities and creative accounting to consistently declare tax losses.

5.5 An integrated system

The current online payment and filing platform should be integrated with other online systems and allow for information sharing with other relevant systems to completely seal off any loopholes associated with filing fraudulent returns and paying the incorrect amount of tax. i tax for instance should be integrated with the following relevant state departments and financial institutions for more effectiveness:

- Immigration Department to narrow down on expatriate and non-resident tax payers;
- Ministry of Lands to closely monitor stamp duty and other capital gains tax involving land;
- The State Law Office (registrar of companies) to include in the tax net all newly registered companies;
- The Ministry of Transport to closely compare notes with the Registrar of Motor Vehicle;
- All County Governments receiving land and property rates. This will be a first step to aid in the mapping out of Real Estate properties and earmark landlords for the taxation of their rental income.
- All banks and insurance companies for relevant financial information and net worth of taxpayers.
- Registrar of Persons; Births and Deaths to determine relationships and consanguinity especially in the directorship and ownership of complex corporate structures.

Usually, in the case of KRA audits, the taxman has a very difficult time obtaining this information from taxpayers who may be unwilling to disclose to aid tax evasion. A proper linkage of highly automated systems will ensure such cases are easily curtailed.

This has been tried and tested in the developed economies of the world such as The United States of America, Germany and South Korea with impressive success.

5.6 Banking the populace

Statistics indicate that only about 20% of the Kenyan population is banked. Banking is a significant auxiliary service to trade and individual and institutional bank records are key third party information avenues especially for the taxman. Because of the risk of fraud associated with manual record keeping, in the event of assessment of an individual or company for tax purposes, an analysis of their bank records will assist to more accurately determine their taxable income and allowable expenditure. Treasury needs to establish avenues of banking the unbanked population as their buying and selling habits are of interest to the taxman in this modern times.

6. Administrative reform options

The KRA is currently bedeviled by capacity constraints in terms of staff and this has greatly hampered compliance especially in the informal sector. The issue of high costs associated with revenue collections has forced the taxman to rationalize staff and put more effort only where he gets maximum revenue. This has caused the informal sector to be largely ignored.

6.1 Specialized units

The current organizational structure of the KRA is largely dictated by the contribution of each sector to the public coffers which is reasonable. However, if the government is serious about broadening the tax base to include among other contributors the informal sector, there is an urgent need to have a specialized unit or desk for TOT. Instead of lumping the turnover tax regime in the midst of the general Domestic Revenue Department, there is need to segregate the taxpayers so as to pay specific attention to the potential taxpayers in the informal sector.

6.2 Enforcement

With a specific reference to the informal economy, the government ought to enhance voluntary compliance that is achievable through the establishment of a robust enforcement presence. This among other benefits has a psychological effect on the taxpayers that any detectable instance of non-compliance is punishable. With the aid of modern technology, spontaneous spot checks by the KRA officers and impromptu audits, there will certainly be an increase in the levels of compliance by taxpayers.

As a result of enforcement lapses for instance, the government is losing billions in tax revenue from revenue leakages in the music and entertainment industry, as well as locally and internationally organized athletics and sporting events. Certain opportunistic taxpayers have hidden their business activities which should ideally attract tax in religious and philanthropic activities which are not taxable to evade the taxman's noose.

6.3 Training and sensitization

A deliberate attempt to continuously train taxpayers is one of the ways that will help ensure the quality of record keeping is enhanced especially among the semi-literate and illiterate populace transacting volumes in the underground economy. The current "regional taxpayers week" campaigns organized by the KRA is a step in the right direction although it is considered elitist by the traders of the informal sector since it only focuses on 'serious" tax payers. The campaigners need to transform this notion by inviting all stakeholders in the informal sector to also update their tax compliance knowledge.

In Jurisdictions like Tanzania Mainland & Zanzibar for instance, the government is encouraging proper bookkeeping by applying lower presumptive tax rates on small business establishments meeting certain acceptable record keeping standards.

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6.4 Recognition

Every year, the KRA holds a gala to recognize the biggest taxpayers in the country. By default, this award has always gone to large multinationals, parastatals and local companies in manufacturing, banking, telecommunications and processing industries. Ironically, the same taxpayers have been rewarded over and over by virtue of their sizes and such names as TSC, EABL, KCB, Safaricom and Barclays have become synonymous with these awards.

It is a good initiative to recognize taxpayers as this implicitly encourages a sustained compliance attitude on their part to continually obtain the corporate bragging rights essential for status in the highly competitive business environment. Unfortunately, such awards have the effect of dwarfing the incognito players in the informal sector and create to them the impression that they are not significant players in the economy.

The government should thus consider expanding such taxpayer recognition mechanisms to capture the aspirations of the entire economic spectrum including rewarding the informal sector not for their tax contribution but on such aspects of proper record keeping and general organizational efficiency.

6.5 Economic stimulus programs

The informal sector is potentially the largest employer in the country with a significant contribution to the country's GDP. Government through the Ministries of Industrialization, Devolution and Planning must identify avenues of supporting the "Jua Kali" sector. Logistical, financial and technical support needs to be channeled to this sector to spur progressive development and create employment. The government should consider options such as issuing interest free (or subsidized) loans for informal business startups and setting up informal business training academies to enhance their business management and record keeping skills at no cost. Such stimulus should also help reduce the cost of registration and provision of necessary and decent infrastructure like premises to spur growth in the sector.

7. Legislative reforms

As discussed above, one of the main reasons why the TOT regime has underperformed in Kenya is because very few taxpayers falling in the ambits of the TOT framework have registered their business. Even for the few who are registered, there still exists a challenge of incomplete or inadequate records.

A similar problem is experienced in the neighboring jurisdictions of Uganda and Tanzania. However in Tanzania, the menace has been partly solved by introducing a slight adjustment to the legislation as discussed below:

7.1 The Tanzanian Presumptive income tax model

According to the application of the Tanzanian Income Tax Act (2004), businesses are categorized into small entities under the presumptive income tax regime not required to maintain audited accounts; and medium and large scale entities taxed under the corporation tax regime required by the TRA to prepare accounts certified by the NBAA (T).

7.2 Rates of tax

Unlike in Kenya where a flat rate of three percent is applied on the annual turnover regardless of any other considerations, in Tanzania, tax is payable depending on the level (extent) of record keeping of the taxpayer. Failure to keep proper and complete records necessitates the tax being paid by estimation settled between the taxpayer and officers of the TRA.

Below are the graduated scales of presumptive income tax in Tanzania.

Annual turnover	Tax due with complete records	Tax due with incomplete records
Below TShs. 4 Million	Nil	Nil
Between TShs. 4 Million & TShs.7.5 Million	TShs. 100,000	2% of annual turnover in excess of 4 Million
Between TShs. 7.5 Million & TShs.11.5 Million	TShs. 212,000	TShs. 70,000 + 2.5% of annual turnover in excess of 7.5 Million
Between TShs. 11.5 Million & TShs.16 Million	TShs. 364,000	TShs. 170,000 + 3% of annual turnover in excess of 11.5 Million
Between TShs. 16 Million & TShs.20 Million	TShs. 575,000	TShs. 305,000 + 3.5% of annual turnover in excess of 16 Million

(Source: Tanzania Revenue Authority)

Unlike in Kenya where a flat rate of three percent is applied on the annual turnover regardless of any other considerations, in Tanzania, tax is payable depending on the level (extent) of record keeping of the taxpayer. Failure to keep proper and complete records necessitates the tax being paid by estimation settled between the taxpayer and officers of the TRA

A change in the TOT law in Kenya should be amended in similar fashion. Such a system if adopted in Kenya will not only encourage voluntary registration for low income traders due to lower rates of tax but also encourage complete and orderly record keeping for the higher income traders so as to enjoy the subsidized rates associated with complete records.

Conclusion

There is an overwhelming need to obtain a mechanism of regulating the activities of the informal sector in order to prudently quantify and incorporate their contribution to the country's GDP and to tax them fairly on their earnings.

According to the tax legislation currently applicable in Kenya, none of the major tax heads of VAT, PAYE, WHT, Corporation tax and Excise duty were specifically modeled with the informal sector in mind. In terms of performance, these are indeed the greatest earners but none of them is keen on expanding the tax base to include the informal sector players.

Turnover tax introduced in the latter months of 2006 is the only channel being used by the government to reign in on the untaxed income in the informal sector. However, the performance of this brainchild has been dismal due to among other things:

- The hands off attitude of the nation's tax administrators who seem to have overlooked TOT as a key revenue driver because of low revenues associated with small businesses;
- Inadequate capacity and competence among the players in the informal sector to proactively keep business records essential for estimating their tax liability;
- The lack of an effective technological and enforcement platform which will make it easier for small traders to register their establishments and reduce instances of tax delinquency.

Embracing technology and building capacity for members of the sector through targeted economic stimuli packages meant to upgrade current infrastructure will go a long way in ensuring there is increased revenue generated by the sector players subject to tax. That will eventually yield better tax returns in the long run than the current approach taken by county authorities to increase the tax rates on virtually anything and everything.

Finally, intellectual tax policy debates and research on the reform options and potential of this sector in broadening the nation's tax base should be encouraged. The nation's current constitutional dispensation has established devolved units of government with enormous resource requirements. It is therefore of paramount importance to prioritize strategies of unlocking the economic potential of this sector and ultimately the County Governments if the Nation's Vision 2030 agenda is to become a reality.

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