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Informal Sector and Taxation in Kenya: Causes and Effects

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Abstract: *Finance whether public or private, domestic or international is one of the pillars for sustainability of any state. Any government/state needs funds to finance its institutions, agencies, development projects, its security apparatus, to pay workers and to finance its social enterprises just to name a few. Public finance is thus pertinent for growth and sustainability of any economy and can be either domestic private or domestic public, international public or international private finance, it can also be blended finance. Either way, public finance is critical for financing every economy that aspires for sustainable development. This is because revenue or tax is used not only to fund education and health which are key pillars for promotion human capital growth but also helps in supporting the growth of local economy through development of infrastructure which support the local business networks and, cash transfers and subsidies which help induce supply and demand in local markets. Tax administration and policy should be among the biggest concerns for any struggling economy. Every country desires to have a tax administration instrument that is efficient in collection of the taxes and a tax payer base that is fully compliant. This paper will analyze the causes and effects of the Informal sector on revenue collection in Kenya. It shall draw from secondary data findings in Kenya and through meta-analysis conclude that Kenya needs to relook its tax administration and policy if it is going to make progress in Public finance.*

Key Words: Public Finance, Tax, Tax Policy, Tax administration, Growth
Research Area: Public Finance
Paper Type: Policy Paper

1. INTRODUCTION

Financing whether public or private, domestic or international is one of the pillars for sustainability of any state. Any government/state needs funds to finance its institutions, agencies, development projects, its security apparatus, to pay workers and to finance its social enterprises just to name a few. Public finance is thus pertinent for growth and sustainability of any economy and can be either domestic private or domestic public, international public or international private finance, it can also be blended finance. Either way, public finance is critical for financing every economy that aspires for sustainable development (UN 2015). Revenue or tax is used not only to fund education and health which are key pillars for promotion human capital growth but also helps in supporting the growth of local economy through development of infrastructure which support the local business networks and, cash transfers and subsidies which help induce supply and demand in local markets. Tax administration and policy should be among the biggest concerns for any struggling economy. Every country desires to have a tax administration instrument that is efficient in collection of the taxes and a tax payer base that is fully compliant. This paper will analyze the causes and effects of the Informal sector on revenue collection in Kenya. It shall consider the current tax system and policy and try to identify how this challenge is enhanced and how it is affecting both the tax authority and by extension the tax payer in collection of revenue It shall also propose policy as well as administrative recommendations on how to tax the informal sector.

This paper shall discuss the different taxes applied in Kenya and the causes and effects of informal sector on revenue collection the Kenya. The paper shall also give some recommendations on how the KRA can improve taxation in the informal sector. The paper shall draw from different scholars and government documents to build the case. Due to the limitation of the paper size, this paper shall narrow down to domestic finance.

2. TYPES OF TAXES APPLIED IN KENYA

Revenue collection in Kenya is done by Kenya Revenue Authority (KRA) which is an autonomous body founded under the laws of Kenya. There are different types of taxes in Kenya, the main ones are income tax, value added tax (VAT), Capital gains tax, import tax, VAT on imports, turnover tax and taxes collected by the customs department. Understanding the challenges faced by the tax collection body requires a good understanding of the kind of taxes applied in Kenya, the rates and how they are applied.

2.1 Income Tax:

This is the tax levied on all forms of incomes in Kenya. It can be from a business or from personal income as an employee. The income taxes are divided into four classes. First, Pay as You Earn (PAYE) which is the tax levied on individuals in gainful employment. The current standard rate is at 30%. Every individual who is taxed under these terms is entitled to a tax credit or tax relief from KRA, known as personal relief. Insurance and mortgage relief is also available from eligible persons. Second, corporation tax which is income tax levied on companies. Resident companies are currently taxed at the rate of 30% of the income while non-resident companies are taxed at the rate of 37.5% of income.

Third, Withholding Tax which are taxes collected at source from the following kind of incomes; interest, royalties, management or professional fees, commissions, pension or retirement annuity, rent, appearance or performance fees for entertaining, sporting or diverting an audience. The tax rate is applied differently depending on different entities and whether the entity is resident or non-resident. Generally, the tax withholding ranges from 5%-20% 10% - 30% for residents and non-residents respectively. Fourth, the advance tax applicable to taxi Cabs and other public service vehicles. It is a tax partly paid in advance before a public service vehicle is registered or licensed. For service provision vehicles like trucks and Lorries, the tax is KS 1500 per ton per year or KS 2400 whichever is higher. For passenger vehicles, the tax is KS 60 per passenger capacity per month or KS 2400 whichever is higher (Kenya Revenue Authority 2015).

In all the income taxes, the employees are required to register with the Kenya revenue authority and obtain a Personal Identification Number (PIN) which they are supposed to supply to the employer for the purposes of remission of taxes. At the end of every financial year, all employees are required to file tax returns with the KRA. Similarly, companies, stock agents and public service providers are required to register their services with KRA, obtain and PIN for the company or entity and are required to file tax returns at the end of financial year.

2.2 Value Added Tax (VAT):

This is the tax charged on supply of taxable goods or services made and provided in Kenya and on importation of taxable goods or services into Kenya. All goods and services are taxable in Kenya except those that are excluded through relevant schedules. Generally, VAT in Kenya ranges from 0% for tax exempt goods to 12% for those partially exempt and 16% as the standard rate for VAT (KRA 2015).

2.3 Capital Gains Tax:

This is the tax levied on the excess value earned after a property has been transferred. A transfer takes place where a property is sold, exchanged, conveyed or disposed off in any manner; or on the occasion of loss, destruction or extinction of property; or on abandonment, surrender, cancellation or forfeiture of, or the expiration of rights to property (KRA Website 2015). Capital gains tax currently at the rate of 5% is due and payable upon transfer of any property and there are penalties in case of non-compliance.

Every business is required to register with KRA, obtain an identification number and VAT electronic systems. They are also required to file their tax returns either manually or online at the end of each financial year.

2.4 Import Tax, VAT on Import and other Levies:

Import tax is the tax levied on all imported goods except those that are tax exempt or those for an organization that has been exempted from tax like charities. The customs service department is responsible for collecting and accounting for income tax as well as VAT on imports. Other taxes under this department are; petroleum development levy, sugar levy, road maintenance levy, import declaration fee, road transit toll, directorate of civil aviation fees, air passenger service charge, Kenya airports authority concession fees, fees on motor vehicle permits.

Most of these taxes are payable at the ports, airports and on the roads where the customs service department officials are placed at different collection points for the facilitation of the same. They are also responsible for facilitation of legitimate trade and protection of society from entry of prohibited goods. (KRA 2015).

2.5 Turnover tax:

Turnover tax (TOT) was introduced by Finance Act 2007 through a provision of the Income Tax Act, cap 470, and was effective from January 1, 2008 (Simiyu 2010). It is the tax applicable to any resident whose turnover from business exceeds KS. 500000 but does not exceed KS 5 million annually and it targets traders, artisans and those working in market stalls, in residential houses and other open places and the applicable rate of tax for TOT is 3% charged on the gross annual sales of any the business entity (Simiyu 2010 & Mpapale 2014). So far this is the best attempt that KRA has made towards taxing the informal economy.

3. WHY TAX?

According to World Bank, Kenya’s GDP was 5.7% as per the 2013 statistics (World Bank-Kenya 2013). The GDP is projected to go up to 6.9% this year and 7.2 % in 2016 (IMF-Kenya 2015). Although GDP is a contribution of many factors like production and export of goods and services, it depends very much on the revenue collection for its enhancement. Revenue funds government institutions and agencies, development projects, infrastructure, social services like education and health. The effect of entities that are running sustainably and efficiently results to improved GDP in any country.

Taxation is thus very critical to the growth of Kenya as a growing economy. Tax compliance which broadly means, meeting legal obligation imposed by a tax system, is a major problem in many developing countries including Kenya. The tax non-compliance in

Kenya is either from tax evasion or tax avoidance. According to the former KRA commissioner general, Kenya has a tax gap of 40%, relatively big compared to tax gaps in developed countries like Singapore, New Zealand and Denmark which have 10% and US, Canada and Chile which have 20% tax gap (Waweru 2004). Although Kenya's desire is to reduce and maintain this tax gap at a relatively decent level, it must address some of the challenges facing tax administration. There are many factors affecting tax administration in Kenya but this paper will narrow to the challenge of informal economy. It shall consider the possible push factors to the informal economy, the effects it has on revenue collection, and shall conclude with policy and administrative recommendations on how to address the issue.

4. INFORMAL ECONOMY AND TAXATION IN KENYA

Informal economy in Kenya is commonly referred to as 'jua kali' literally meaning hot sun. The name was coined by the traders and was used to describe the kind of activities they engage in, mostly done under blazing sun. It is mainly concerned with production, distribution and sale of household, farming and industrial items (Mpapale 2014). Informal economy or sector in Kenya is normally viewed as comprising of micro and small enterprises which are not well organized mostly activities of petty traders operating in the streets in the main urban areas. Most of them use labor intensive technology and are unregistered (IEA-Kenya 2012 & Simiyu 2010). "They produce and distribute basic goods and services in unregulated competitive markets that lie outside the regulatory framework of either national or municipal government" (Ouma 2010). In 1993, 910,000 micro and small enterprises were identified in the National Baseline Survey and they employed about 2 million people. In the second baseline survey in 1999, 1.3 million such enterprises were identified employing about 2.4 million people (IEA-Kenya 2006). Most of these businesses are non-agricultural and are non-account, they run from pockets and briefcases and are characterized by sole proprietorship with minimal employees if any, who are mostly casual. They lack formal organization, they use very low technology and they mostly don't have fixed business place (Mpapale 2014). With the emergence of phone money transfer technology in Kenya, most businesses are transacted and money transferred through the phone or received as liquid cash. The phone money transfer systems can also be used by the vendors as their banking system which means they don't have to bank their money with traditional banks. Typically, the activities of informal sector are not regulated by laws such as environmental, labor and taxation. However, the activities are subjected to the local authorities like chiefs and local government which regulate business orderliness as well as legality. Most of these activities are not included in the Gross Domestic product (IEA-Kenya 2012) because their production is not accounted for and they generally don't remit any taxes except for the business permit fee they pay to the local governments.

Studies estimate that the informal sector account for 35-50% of the GDP in many developing countries. In Kenya, the informal sector is estimated to be 34.3% and is accounting for 77% of total employment (IEA-Kenya 2012). The sector accounts for an estimated 25% of the national GDP (KNBS Economic survey 2012). The youth aged between 18-35 years make 60% of those working in the informal sector while 50% are women. 61% of the total labor force work in non-agricultural employment with 35% of urban population and 59% of rural households respectively involved in small businesses (Ouma 2010). With this kind of statistics, the informal economy is hard to ignore in Kenya. Its contribution in provision of labor as well as giving livelihoods and poverty alleviation in many Kenyan households cannot go unnoticed. Of importance is the revenue share that the government is losing given that over 50% of the labor force in Kenya is in the informal sector.

Informal economy is one of the major concerns that affect tax administration in Kenya. In Kenya, tax is the largest source of government resources and it constitutes 80.4% of the government revenue. Taxes are very necessary for raising revenue which in turn provide public goods for the population. They are used to raise sufficient revenue to fund public spending avoiding excessive public borrowing. They are also used to mobilize revenue in equitable ways minimizing its disincentive effects on economic activities (IEA-Kenya 2006 & Simiyu, 2010). If big part of the population is not paying the fair part of the tax, then there is not only tax injustice for the tax payer but also the government shall not be able to run efficiently without the funds to meet the government expenditure. Kenya has moved from being a low tax burden to a high tax burden country, which implies that the country faces obvious need for more tax revenue to maintain public services (IEA-Kenya 2006). Simiyu (2010) argues that although a tax policy cannot solely be concerned with minimizing tax evasion, the fact of tax evasion and its consequences alters the way in which taxes impact on economic efficiency and income distribution. Thus, addressing the issue of informal economy is essential for economic growth and efficiency of the country.

5. PUSH FACTORS THAT CONTRIBUTE TO A LARGE INFORMAL SECTOR

5.1 Informal sector is an unaddressed historical policy issue:

Informal economy is a policy issue as old as the Kenya's pre-independence days. Informality is synonymous to many business activities in Kenya and has been receiving acceptance from most stakeholders irrespective of its negative effects to the economy. First, the informal economy or second economy is a segmented economy, much like the colonial days where the indigenous people were not allowed to access state protection and services. It is an economy whose activities take place outside the state due to mistrust in state institutions, lack of representation and lack of appreciation by policy makers of the role of this sector in job creation, poverty alleviation and economic growth (Ouma 2010 & Waris 2009). Second, Kenyans are not generally comfortable with payment of taxes, there is no tax paying "culture" both for those in political power and those who are not. This lack of tax paying culture creates a mistrust between the tax payers and those collecting taxes creating high levels of non-compliance (IEA-Kenya 2006). Kenyans feel like paying tax is government exploitation, especially when those in high positions try as much as possible to evade taxes and in turn squander the public funds. Third, the existing legislation does not address the problems of the Kenya's informal economy largely because there is lack political will and commitment by policy makers (Ouma 2010). The informal sector is always used as a bait by political leaders to earn re-election. They temporarily support the informality of businesses at times when they want election to office and it becomes a complex problem to deal with when they are making laws.

5.2 Informal economy is a tax administration issue:

Informal economy is also a tax administration issue. First, the government lacks the tax relevant information like the amount of income farmers, small and medium scale entrepreneurs receive annually (IEA-Kenya 2006). This is partly contributed by the invisibility of the informal sector and lack of disaggregated data on the people operating such business. All businesses are expected to voluntarily register with the Kenya Revenue Authority and obtain a Personal Identification Number (PIN) for the purposes of taxation. Most people choose not to register either because they are ignorant about it or they just don't want to pay taxes and don't want to be caught up with by the law.

Second, the small and medium businesses which do not qualify for VAT are expected to pay the turnover tax set at the rate of 3%. These SMEs are characterized by the ease of entry and exit, small scale activities, self-employment with high level of family workers and apprentices (Simiyu 2010). These businesses which mostly are not registered have no access to credit and other sustenance mechanism thus their ease entry and exit. The turnover tax has not yielded much as the revenues are poor and gradually decreasing mainly contributed by easy entry and exit of the SMEs (ibid). These small businesses because of their unpredictability are most likely to evade tax or fail to register for taxation because most of them may be seasonal. An example is a vendor who hawks fruits and ice-cream during summer but during winter he moves into clothes business. Such a vendor has no specific area he is operating from nor does he have specific goods because he works with the season and provides the goods and services required for that season.

Third, the registration and tax filing process is very complex for the people operating in informal businesses who are mostly of low education status. The registration process design does not take into account the local peculiarities (IEA 2006). The processes are also bureaucratic involving many agencies and multiple crosschecks. Mpapale (2014) argues that, "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". Lack of coordination from various government agencies causes delays especially on obtaining business licenses. For those who qualify for VAT, the process is also expensive and time consuming which is a disincentive to the tax payer (Simiyu 2010). The county governments have also been increasing costs of obtaining business permits as well as operating licenses for such small traders in their jurisdiction (Mpapale 2014). Such arbitrary and unpredictable increases of registration costs which happen every year are discouraging many business owners from registering their small businesses.

5.3 Lack of inclusion of informal sector:

Most scholars and researchers have been looking at the problem of tax evasion from the perspective of the tax collector. Very little interest has been given to what the tax payer thinks of taxes. Waris (2009) observes, "There remains a need to justify taxation and to legitimizeits collection in some developing countries". This is because in many of these countries, tax payers do not see the impact of the taxes they pay. The most of affected group is the low-income earners in which most of those in informal economy fall. Most of them live and work in pathetic conditions, lack social security and lack access to credit. It is one thing for people to pay taxes, it is another thing to show them what their taxes do for them. Bird (2010) argues that, if people want more public services and trust that their government will try to deliver such services as effectively and efficiently as possible, they are more likely to support efforts to raise taxes than they are when experience has taught them to expect little in the way of benefits from increased government activity.

This implies that lack of evidence of how taxes are serving those in the informal sector discourages them from payment of taxes. Lack of recognition by the policy makers of the need for tax collection on behalf of the citizens, and the subsequent benefits of redistributing the revenue to citizens is a disincentive to the tax payers (Waris 2010). Thus "taxes imposed without adequately representing the interests of the people being taxed are unlikely to be collected easily" (Bird 2010, p. 3). The government has not only been reluctant in addressing the social and economic issues affecting those working in the informal economy but has also not involved the informal sector in formulation of the current policy reforms regarding business regulations and taxation laws (IEA 2012). In response, many traders are not willing to respond to the call to pay tax even when the tax rate is as low as it is for turnover tax.

5.4 Corruption and taxation in Kenya:

Corruption is one of the major undoing of the tax processes in Kenya. This is because most stakeholders, from senior government of officials to KRA officials to the petty traders understand that instead of paying tax, you can always pay your way out of it. Simiyu (2010) argues that turnover tax collection which is currently required to address the informal taxation problem, is riddled with corruption and collusion among the tax administrators. This is mostly a result of unclearly defined roles, duties and function which leaves gaps of unwarranted high discretion and creates an opportunity for tax official to reap from the taxes. When the tax payer discovers this, then tax evasion looks normal as it is legitimized by those in charge of collecting taxes.

6. THE NEGATIVE IMPACT OF INFORMAL ECONOMY

Although informal is providing many low-income earners with livelihoods, it has negative impacts on any economy. In Kenya, the following impacts are felt;

6.1 Revenue loss:

The fact that the informal sector whichprovides more than 50% of Kenya's population thrives outside the formal and legal frameworks of business operation implies that Kenya is losing a lot of revenue through this sector. That explains the tax gap of 40% in Kenya. In the nineties, the potential taxable income accruable from the sector was average of 4% of GDP. This implies that the government had a potential of expanding the tax base by the same proportion. Empirically, in the year 2013, The National Bureau of Statistics estimated Kenya's GDP to be KS 1.68trillion. Going by the current the most recent tax potential as a percentage of GDP which was 7.66% in 2008, and 7.66% of 1.68 trillion is KS 128.7 billion, which implies that Kenya lost this proportion of revenue through the informal sector (Mpapale 2014 & IEA 2010). This money is enough to cover 4 times the budget of health which is currently 41.5 billion (Africa tax spotlight 2012). This kind of revenue loss warrants urgent action by all policy actors to regularize the informal sector.

6.2 Undue competitive advantage over the formal sector:

In Kenya, both the formal and the informal sectors produce similar goods which only differ in the quality, branding and packaging. The fact that they don't pay taxes gives them an undue competitive advantage over the formal sector in that they can afford to sell their goods at relatively lower prices compared to the formal sector because they are not obliged to include the VAT element as opposed to formal businesses. Mpapale (2014) argues that, these goods serve the same purpose and compete for the same resources and markets. This kind of scenario poses a danger of either having the formal business close because of lack of business or join the informal economy where doing business is more lucrative forcing the informal economy to grow even bigger. This is also a form of an injustice that can easily discourage new entrants from entering business formally.

6.6 Unequitable treatment:

The fact that businesses that have the potential of paying tax are running and using public resources without making their fair contribution results to unequitable treatment. Mpapale (2014) points out that "one of the hallmarks of a sound tax system is equity and fairness…a principle which holds that individuals with the similar ability to contribute to the public coffers should contribute the same or similar amounts". For a tax system to be neutral and equitable, it should treat people or entities with similar circumstances and income equally, otherwise one will have an undue advantage over the other. Failure to tax the informal sector who benefit from public goods like infrastructure, and social services funded by the tax payer creates inequality which leads to tax injustice.

In summary, the informal sector leads to revenue loss by the economy, causes or gets an undue economic advantage over the formal sector which threatens the growth of the formal sector and perpetuates tax injustice in that it is not contributing its fair share of the tax for redistribution in funding public goods which are to be accessed by all.

7. PROPOSED RECOMMENDATIONS FOR TAX REFORMS IN THE INFORMAL SECTOR

From the above discussions, Kenya needs to address the problem of informal sector which is not only threatening the economy of the country but is also slowly formalizing a culture of inequality and non-compliance in relation to tax. There are several steps that the state and its authorities can take to improve compliance in the informal sector.

7.1 Policy and administrative recommendations:

First, the state needs to give the informal sector a cause to pay taxes by adequately representing their interests through having people enjoy the benefits of the taxes they pay. This way, people can give more if they can see what the taxes are doing for them. Second, there is need for informal sector to be involved in formulation of policies that affect. While the formal sector is normally well represented and their grievances are taken by policy makers, the informal sector are not consulted as many of them do not have unions because they are not registered. Third, good marketing of tax policy may be a major boost for tax reforms (Bird 2010, p. 4). This can be done through a combination of many strategies like providing effective and efficient public services, increased accountability through information sharing and having the civil society and other groups stimulate policy dialogue through which citizens get to know their rights and entitlements as well as their responsibilities and obligations in relation to taxes (TJN-A Newsletter 2012). This way, the informal sector will not only feel recognized but also, they will be educated on different taxation strategies and the importance of their contribution in nation building.

Fourth, the government needs to have major technology reforms introduction of a cashless economy which can be used to monitor funds through transaction tracking to ensure that the government can have a rough estimate of the annual turnover of any business. Credit cards as well as visa cards can be tracked to ascertain that what the taxpayer presents as his expenditure is correctly captured. In Kenya, there is an advantage of phone money transfer which is commonly used by the informal sector. The authorities can work with phone service providers to avail every transaction by a registered phone holder. Any transactions that indicate large sums transferred or received by a person who is not a registered tax payer and there seems to be evidence of business going on, then this person can be required by law to pay taxes.

Fifth, KRA need to fully automate its tax collection system to ensure that there are no tax leaks and manipulation of taxes through understatement of turnover or overstatement of expenditure. Sixth, the government needs to invest in forming an integrated online system where all government ministries and departments are linked together to ensure that information concerning any tax payer can be accessed anywhere in any government department. This will ensure that KRA can access any fraudulent or erroneous tax filing which cause leaks in the tax systems.

Seventh, the treasury needs to establish avenues of banking the unbanked population. The bank in formation can easily be used for analysis of a business or person who is not complying with tax by tracking their buying and selling habits. (Mpapale 2010). If the person is not complying KRA can work with the bank to tax the income of anyone who is not registered with the tax authority. Finally, KRA needs to conduct other administrative reforms like setting a specialized unit or desk for the informal sector taxation, deal with the internal issues of corruption, instilling a culture of compliance, training and sensitization of taxpayers, recognition of the informal sector and economic stimulus programs for the informal sector (ibid). Through this the entities in the informal sector will not only appreciate paying taxes but will have access to other services like credit and government grants which they could not access if they do not comply.

8. CONCLUSION

This paper has discussed the types of taxes applied in Kenya, why the government should tax and the challenge of informal sector. It has further discussed the push factors and effects of the informal sector to the economy. The paper concluded with policy and administrative recommendations than can be of great help in improving taxation of the informal sector. The paper clearly shows that although the informal sector may be alleviating poverty in Kenya, it is having adverse negative impact to both the government and the business community. Revenue loss, undue competitive advantage and tax injustice are the main effects which are factors that are not only affecting the government operation but also increasingly perpetuating inequality and tax injustice. There is therefore an urgent need for the government and all stakeholders to face this ever-growing sector.

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