UNU WIDER

KENYA REVENUE AUTHORITY
ISO 9001:2015 CERTIFIED

ESTIMATING THE PERSONAL INCOME TAX GAP IN KENYA

Clement Otindo, Jane Kanina & Faith Abuna
Kenya Revenue Authority

INTRODUCTION

- Tax revenue is a significant source of public revenue for the majority of countries, Kenya included.
- It is considered the most reliable way of financing public expenditures.
- Governments around the world put in concerted efforts to improve tax compliance but the extent of taxpayer non-compliance (tax gap) remains fairly unknown in most developing countries.
- Tax gap- the difference between potential tax revenue from the tax base and actual revenue.
- In Kenya, PIT is imposed on income derived from business, employment, rent, dividends, interests, and pensions among others.
- It is charged for each year of income on all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya.
- The settlement of income tax liabilities on salaried income is done through third-party reporting, therefore, minimizing non-compliance since employers have little incentive to under-report employees' taxes
- However, self-reporting for self-employed individuals has been associated with taxpayers not reporting their incomes or under-reporting incomes which results in high non-compliance.
- Personal Income Tax (PIT) in this context excludes PAYE

MOTIVATION

- Kenya Revenue Authority's 8th Corporate Plan aims at improving tax compliance by reducing the tax gap and achieving revenue growth above the nominal GDP.
- Direct taxes constitute the bulk of Kenyan tax revenue. Over the last four years, they contributed about 48% of the total tax revenue collected, though this contribution has declined from 51% in 2018/19 to 49% in 2021/22.
- Personal Income Tax (PIT) which forms the bulk of the direct taxes has also experienced a downward trend as a share of total tax revenue from a contribution of 32% in 2018/19 to 25% in 2021/22.
- The PIT to GDP ratio also declined from 5.7% in 2017 to 4.9% in 2021 recording an average of 5.2% over the period. The ratio compares poorly to the 9% average for OECD countries.
- With the fiscal constraints in Kenya (widening fiscal deficit and a growing debt burden), there is need to understand the reasons behind the relatively low collection from PIT and estimate the amount of revenue the country loses from this tax head.
- It is against this backdrop that this study sought to estimate the personal income tax gap in Kenya, with a specific focus on estimating the potential revenue as well as the compliance gap of PIT

OBJECTIVES

The main objective is to estimate the personal income tax gap in Kenya. Specifically, the study seeks to;
- Estimate the potential revenue from the personal income tax base in Kenya.
- Estimate the tax gap of the personal income tax in Kenya.

METHODOLOGY

Data used

1. This study adopted the use of the bottom-up approach and estimated the potential tax revenue and tax gap for 2019 based on available data.
2. Kenya Continuous Household Survey Programme (KCHSP) data for 2019 survey was used to estimate Kenya's potential personal income tax revenue.
3. Income reported in the households' survey ie primary income, secondary income and other income was summed up to get the gross income which was then subjected to tax.

Scenario 1: Application of Effective Tax Rate (ETR)

We applied an effective PAYE tax rate to the annual income to arrive at the potential tax revenue. Since the distribution of income in the data set consists of individuals earning income below and above the taxable threshold, we apply an effective PAYE tax rate to the annual income to arrive at the potential tax revenue.

The effective tax rate was computed as the ratio of the total tax paid (PAYE) to the total taxable income for the year 2019.

The effective tax rate for PAYE in 2019 was 22.2%. We used ETR for PAYE since both PAYE and PIT apply similar tax bands and tax rates.

Scenario 2: Micro-simulation

Step 1: Calculates the taxable income

$taxY_i = Y_i - deduct_i,\ ItaxY_i > 0$ 1

Where; $taxY_i$ is the taxable income, Y_i is the gross income, and $deduct_i$ are the deductions

Step 2: Liability

$X_i = f(taxY_i: Tax\ Structure)$ 2

Tax liability was calculated by applying tax rates and rebates to the taxable income for the period of assessment

Step 3: Theoretical tax liability

The tax liabilities calculated on step 2 were then grossed up to national level using the household weights w_i. The grossed-up tax liabilities were added together to produce the theoretical tax liability:

$Theoretical\ tax\ liability = \Sigma_i^N w_i x_i$ 3

Step 4: Computing the tax gap

To obtain the tax gap, the actual collections (Zo) obtained from the revenue statistics was subtracted from the theoretical tax liability as computed in equation (3). That is;

$Tax\ gap = \Sigma_i^N w_i x_i - Z_o$ 4

RESULTS

RESULTS	Scenario 1: ETR=22.2%	Scenario 2: Microsimulation
Potential tax liability from taxable income (Kshs billion)	405	218
Actual (PIT) collection (Kshs billion)	9.137	9.137
Tax Compliance Gap (Kshs. billion)	395.9	208.863
GDP (2019) Kshs billion	10,238	10,238
Tax Compliance Gap to potential revenue (%)	97.7%	95.8%
Potential revenue to GDP (%)	4.0%	2.1%
Actual tax to GDP (%)	0.1%	0.1%
Tax Gap to GDP (%)	3.9%	2.0%

CONCLUSION AND RECOMMENDATIONS

Conclusion

While there have been concerted efforts to enhance voluntary tax compliance in Kenya, there still seems to be a very big compliance gap with respect to the personal income tax gap.

KRA had the potential of collecting Kshs. 405 billion and Kshs. 218 billion under the first and second scenarios, but only managed to collect Kshs. 9.13 billion, translating to 97.7% and 95.8% to potential tax revenue, and 3.9% and 2% of GDP

The actual PIT revenue collection as a share of GDP is extremely low, falling below 1%.

Recommendations

1. Analyse practical aspects of simplifying PIT administration to improve compliance including:
   - Creating user-friendly forms and clear instructions tailored to the needs of self-employed individuals.
   - Simplify the regulations pertaining to self-employed individuals
2. Risk-Based auditing to identify high-risk self-employed individuals who may be underreporting their income or engaging in tax evasion.
3. Strengthen penalties and enforcement: Ensure that penalties for non-compliance are sufficient to deter tax evasion

WIDER Development Conference 2023 6-8 September 2023, Oslo, Norway