THE SIGNIFICANCE OF VALUE ADDED TAX AS A SOURCE OF REVENUE FOR THE KENYAN GOVERNMENT:

A CASE STUDY OF SELECTED VAT DISTRICTS AND BUSINESS SECTORS

BY

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A Research Project to the Graduate Faculty of the School of Business, United States International University-Africa in partial fulfillment of the requirements for Degree of Master of International Business Administration (MIBA)

United States International University-Africa
May, 2000
DECLARATION

I hereby declare that this project is my original work and has not been submitted, either in the same or in different form to this or in any other University or Institution for a degree.

Signed ........................................... Date ...........................................

This project has been submitted for examination with my approval as the supervisor.

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Dean, School of Business, USIU in Nairobi Date
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DVC, Academic Affairs, USIU in Nairobi Date
Dr. Freida Brown
DEDICATION

I sincerely dedicate this study to my esteemed students and colleagues.

I am deeply grateful for the guidance and support of:

Special thanks to:

Mr. R. Sigel, whose encouragement and dedication remained constant.

To mom

Thanks for everything
ACKNOWLEDGEMENTS

I am greatly indebted to all those who helped me in various ways in the pursuit of this study. My sincere gratitude goes to my family, especially my mother, for her support and continual encouragement.

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LIST OF ABBREVIATIONS

AERC  African Economic Research Consortium
CBK   Central Bank of Kenya
COMESA Common Markets for East and Southern Africa
EAC   East African Corporation
EEC   European Economic Community
FYs   Financial Years
GDP   Gross Domestic Product
GoK   Government of Kenya
GNP   Gross National Product
IEA   Institute of Economic Affairs
IMF   International Monetary Fund
K P & T C Kenya Posts and Telecommunications Corporation
KRA   Kenya Revenue Authority
LTOs  Large Tax Payers Office
MOFP  Ministry of Finance and Planning
PAYE  Pay As You Earn
PSV   Public Service Vehicle
SAPs  Structural Adjustment Programmes
TLB   Transport Licensing Board
VAT   Value Added Tax
WB    World Bank
WTO   World Trade Organization
ABSTRACT

Value Added Tax (VAT) is said to be "the tax of the future". It is a consumption tax that is increasingly being adopted by governments all over the world due to its ability to raise substantial revenue at low administrative and compliance costs. It was adopted in Kenya in 1990.

The study set out to explore the significance of VAT as a source of tax revenue for the Kenyan government. Specifically, the objectives included: (i) determination of the trends in total VAT revenue collections vis-à-vis other tax revenue sources, (ii) comparison of the total VAT collections to the total tax revenue and the gross domestic product, and (iii) analysis of trends in gross domestic VAT collections to the targets set. In addition, establishment and analysis of the various sources of domestic VAT revenue collections by VAT districts and business sectors and coming up with recommendations in light of the findings, constituted the main areas of focus.

Although data was mainly collected from secondary sources by use of fact sheets, primary data was also collected through interview schedules. The data collected was formatted, coded and analyzed using Excel and SPSS statistical packages.

The study revealed that though income tax and customs and excise duties remain the highest tax revenue earners for the Kenyan government, their contributions are declining. Currently, VAT is the third largest contributor to the tax revenue pool and its contributions have been on the increase since 1994, thus confirming its significance as a source of government revenue.

The contribution of VAT to the total tax pool increased from 22.6% in 1994/95 to 24.4% in 1998/99. This was due to better administration and widening of the VAT base. The VAT revenue contribution to GDP rose from 5.25% in 1996/97 to 5.44% in 1998/99, and it was established that there is a positive relationship between GDP and VAT growth rates. However, the direct relationship between the two rates is not reflected in some financial years, implying that there is still a lot of VAT potential to be tapped.
Exchequer VAT targets set by the Ministry of Finance have been achieved and surpassed by the VAT department since 1997/98. The domestic gross VAT targets on the other hand, have not been achieved mainly due to lack of resources, although the variances have drastically declined since 1997/98 due to better administrative measures by the VAT department.

The economic potential of various regions of the country largely determine the receipts of domestic VAT. Well-to-do regions contribute higher VAT revenues compared to the ones less endowed. For instance, Nairobi districts alone contributed over 33% of total collections between 1996 and 1999.

In terms of business sectors, the manufacturing, distributive trade and financial sectors contribute about 80% of the total domestic gross VAT revenue, though great potential is still untapped as the sectors house a large portion of the informal sector.

Major obstacles to effective VAT administration include: lack of resources on the part of the VAT department, inadequate education of the taxpayers, VAT evasion, political interference, poor infrastructure and the general poor state of the Kenyan economy.

In light of the findings, the study recommends that more effort should be put into taxpayer education programmes by the VAT department. In addition, VAT personnel should be trained on relevant computer skills and customer service. To effect this, the government should support the efforts of Kenya Revenue Authority by providing the necessary capital resources required for effective tax administration.
CHAPTER ONE

1.0. INTRODUCTION

1.1. BACKGROUND OF THE STUDY

Kenya's budget deficit has averaged more than 4% of the Gross Domestic Product for the last 5 years (Wang'ombe, 1999) while domestic borrowing rose from 60 billion Kenya shillings in 1992 to 150 billion Kenya shillings in 1998. Interest payment on government debt on the other hand, rose to nearly 30% of the total government debt (IEA, 1998). As domestic borrowing is no longer an appropriate means for financing government expenditure, the government has resorted to other methods of financing including taxation and donor assistance. However, declining donor assistance in the 1980s and 1990s made it quite pertinent for developing countries to look for other sources of government revenue, such as tax revenue (Wang'ombe, 1999).

Kenya Revenue Authority (KRA) was established in 1995, with the purpose of assessing, collecting, administrating and enforcement of laws relating to revenue. The major sources of tax revenue include, income tax, customs and excise taxes, value added taxes (VAT) and road transport taxes (Gupta, 1998). Currently, the KRA collects 86% of total government tax revenue (MOFP, 1999a).

According to Kusi (1998), motivation for less developed countries tax reform has been the need to raise more revenue. In line with this, VAT\(^1\) was introduced in Kenya in January 1990 to replace sales tax as a component of the tax modernization programme. It was to be used to tap the vast internal revenue potential and support the ongoing Structural Adjustment Programmes (MOFP, 1999a).

Ng'otho wa Kariuki (1989) contended that many countries adopted VAT as a result of external pressures, VAT adoption in most developing countries was not voluntary, thus was much more philosophical than practical and hence proved difficult in practice. With the current high inflation rates, economic instability, continuous rise in oil prices, and harsh weather conditions being witnessed in the country, the objective of widening the tax base through introduction of VAT has been somewhat hard to achieve.

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\(^1\) VAT is levied on the value of goods and services at each stage of production until they reach the final consumer. This widens the tax base.
The extent, to which the objective of VAT introduction in Kenya has been achieved, may give light to problem areas in VAT administration and thus narrow down areas of focus. This can be done through the determination of trends of VAT revenue collections vis-à-vis other taxes for a period of time, and analysis of VAT sources in terms of districts and business sectors.
1.2. STATEMENT OF THE PROBLEM

The Kenyan government has been experiencing persistent deficits in its expenditure which have serious consequences to the economy (GoK, 1997). The government finances these deficits using both internal and external sources. However, external sources especially heavy borrowing have not been viable in the long term due to the high costs. As a result, the government has resorted to the use of internal sources chief among these being tax. Arguably, efforts have been made to design a tax system that responds adequately to the revenue needs of the government (Njoroge, 1993).

The government in Sessional Paper No. 1 of 1986, reiterated measures to attract increased savings and investment. To counteract this, a great burden was put on consumption by introducing the VAT (Ngugi, 1994). To achieve the objective of increased tax revenues through the VAT, targets have been set by the Ministry of Finance. Similarly, operational targets have been set by the VAT department to aid in planning and implementation of VAT administration, although there have been variances between the actual and target VAT collections (see Table 1 below). Hence, there exists a need to explore the causes of these variances.

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Domestic Gross VAT Collections Actual (Kshs. Millions)</th>
<th>Domestic Gross VAT Collections Target (Kshs. Millions)</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>15,552</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1995/96</td>
<td>16,148</td>
<td>17,000</td>
<td>(852)</td>
</tr>
<tr>
<td>1996/97</td>
<td>18,476</td>
<td>19,200</td>
<td>(724)</td>
</tr>
<tr>
<td>1997/98</td>
<td>22,129</td>
<td>22,300</td>
<td>(171)</td>
</tr>
<tr>
<td>1998/99</td>
<td>23,804</td>
<td>24,000</td>
<td>(196)</td>
</tr>
</tbody>
</table>

Source: VAT department

Various studies have been conducted on Kenyan taxation including VAT. For instance, Wang'ombe (1999) in his study on the revenue productivity of the Kenyan tax system, concluded that introduction of VAT to replace sales tax has not yet improved productivity of the tax system. On a similar vein, Kusi (1998) argues that a common feature of the tax structure of most developing countries is that they are complex (difficult to administer and comply to), inelastic (non responsive to growth and discretionary policy measures) and thus end up being inefficient (raise little revenue but introduce serious economic distortions).
Despite of this there has been no in-depth study on the actual sources of VAT revenue and explanation for the wide variance between actual and target collections. The intent of this study was to fill this gap by analyzing the domestic VAT revenue contributions by districts and business sectors.

Institute of Economic Affairs (1998) notes that the short term nature of revenue collection often means that the VAT department targets people who are already paying tax, thus the focus is on the more established firms which are paying 99% of their tax, rather than the lesser known firms paying a meagre 1%. An in-depth analysis of sectoral contributions to revenue would give more light to this problem.

1.3. OBJECTIVES OF THE STUDY

The general objective of the study is to establish the significance of VAT as a source of internal tax revenue for the Kenyan government. The period of study lies between the financial years 1994/95 and 1998/99.

The specific objectives are:

1. To determine the trends in total VAT revenue collections vis-à-vis other tax revenue sources.
2. To compare total VAT collections to total tax revenue collections and VAT growth rate to the gross domestic product (GDP) growth rate, thus establish its contribution to internal revenue.
3. To compare and analyze the trends in domestic VAT collections and targets of the same in order to establish the variance.
4. To establish and analyze the various sources of domestic VAT revenue collections that is, by VAT districts and business sectors.
5. To take recommendations in the light of the study findings.
1.4. RESEARCH QUESTIONS

1. What have been the trends in total VAT collections from 1994/95 through to the 1998/99 financial years?

2. What have been the trends of total collections from income tax, customs and excise and road transport taxes from 1994/95 – 1998/99 financial years?

3. What have been the major obstacles faced in domestic VAT collection?

4. How are VAT targets set, and what measures has the VAT department put forth to aid in achieving these targets?

5. What are the major obstacles faced by the department in achieving these targets?

6. What have been the trends of domestic VAT collections in terms of districts and sectors since 1994/95 – 1998/99 financial years?

7. What has the VAT department done to minimize VAT evasion?

8. To what extent has VAT become a significant source of government revenue?

1.5. SIGNIFICANCE OF THE STUDY

The information provided by this study will be significant to various groups.

To date, VAT is the third largest source of ordinary revenue for the government after customs & excise and income taxes. The rapid growth of the informal sector and the prevalent poor economic times have made tax evasion a problem to reckon with, as it denies the government of potential revenue. Thus, identifying the problem areas in terms of compliance would assist the government in developing appropriate measures.

This study will give the VAT department of KRA an overview of the compliance patterns, and thus assist in selection of taxpayers due for audit and or industry/sector concentration.

Since not much information on VAT is usually released to the public, this study will help enlighten the public on VAT as a whole. It will give them a better understanding of the integrity and fairness of the VAT taxation system and its value to the economy as a whole. This will hopefully encourage them to comply.
Although this study is by no means exhaustive, it will stimulate and trigger forward thinking along the same lines. The study will therefore be used by other researchers, as a starting point to research into this area in further detail.

1.6. ORGANIZATION OF THE PROJECT

The project is organized in six chapters.

Chapter one provides an introduction to VAT and looks at the statement of the problem, and main objectives of the study.

Chapter two outlines the relevant literature associated with VAT in Kenya and around the world.

The methodology used for the study including the data sources, sampling procedures and study limitations are provided in chapter three.

The method of data analysis used is highlighted in chapter four, while the study findings, conclusion and recommendations are set out in chapters five and six.
CHAPTER TWO

2.0. LITERATURE REVIEW

2.1. INTRODUCTION

The widespread objective of any tax reform in low income countries has been to shift from reliance on taxation on imports to domestic taxation by broadening the tax base through VAT and extending the individual income tax base. These reforms have had an effect on the tax burden and productivity and efficiency of the tax systems in various countries. In Kenya these issues have formed the basis of widespread studies on taxation (Odd-Helge, 1995).

According to Wagacha (1999), the revenue GDP ratio (tax burden) in Kenya has shown a trend increase averaging 26.16% over the period 1992/93 to 1996/97. By international standards, this ratio has remained fairly high in the long-term perspective, and the justification has been the continual need for the government to finance the budget deficit.

On efficiency and productivity of taxation in Kenya, studies by Ole and Adari (1975 & 1997) reveal that taxation in Kenya has remained inelastic in respect of income for the past three decades. While there are increases in deadweight costs, higher taxes do not elicit proportionate increases in revenues. Costs of allocative inefficiency of resources triggered by the taxes remain greater than the value of tax revenue collected. In addition, the government receives a declining automatic share of revenue from growth in income even if tax rates do not change.

Njoroge (1993) found that consumption taxes had been pursued with great intensity for revenue purposes between 1972 and 1991. This was in response to the policy of increased reliance on indirect taxes especially consumption taxes to compensate for anticipated revenue loss due to reduced reliance on trade taxes.

In addition, the tax system for the period 1972-1991 was found to have an elasticity of 0.67064. This was a period of increased government expenditure and thus, persistent and growing deficits were an unavoidable outcome. In line with this, the tax system thus requires constant review as the structure of the economy changes.
Wang’ombe (1999), in his study on the revenue productivity and some administrative factors of the Kenyan tax system, concluded that introduction of VAT to replace sales tax has not yet improved productivity of the tax system. Similarly, Kusi (1998) argues that a common feature of the tax structure of most developing countries is that they are complex, inelastic and thus inefficient.

2.2. OVERVIEW OF VAT

2.2.1. Historical Overview

The speed by which the VAT system has spread around the world is unmatched by any other tax in modern times in spite of the lack of a comprehensive VAT anywhere 35 years ago (Shoup, 1990). Immediately after the Second World War, Japan introduced a short lived VAT. France introduced a limited VAT in form of a wholesale level VAT to replace multistage production tax in 1954 (Metcalf, 1990). A comprehensive VAT first appeared in Brazil in 1967. It was designed to overcome the defects of turnover taxation and secure a greater degree of tax co-ordination among states of the Brazilian Federation (Shoup, 1990). Denmark became the first country to introduce comprehensive VAT at national level in 1967. In the following years VAT was adopted by other member states of the European Economic Community (EEC) to replace their turnover taxes. By 1990, more than 50 countries in the world had adopted VAT, to raise substantial government revenue at low administrative and compliance costs.

In Kenya, VAT was introduced in 1990 as a replacement for the old sales tax on imports and domestic manufactured goods. It was introduced so that the taxation on consumption could be expanded to a broader base. Increasingly, tax on consumption allows reductions in tax on investment.
2.2.2. Features of VAT

VAT is considered to be neutral with respect to foreign trade and does not distort domestic production and distribution. Secondly, it is also neutral in regard to the production techniques that a business adopts; that is, it makes no difference for tax liability whether a product is manufactured with a capital or labour intensive technology. Thirdly, the forms or methods by which business is conducted do not influence it. Fourthly, it is a relatively stable source of government revenue since consumption as a share of GDP fluctuates little. Lastly, VAT is a flexible tax instrument. A change in the rate translates immediately into more or less revenue.

In comparison to sales tax, VAT is preferred for four reasons: potential coverage of tax, ability to distinguish producer from consumer goods, ability to effectively correct border tax adjustments and administrative feasibility (Ngotho wa Kariuki, 1989).

2.2.3. Methods of Computing VAT

VAT can be computed in various ways including the use of credit and subtraction methods. The former requires that the amount of VAT charged is explicitly stated on the invoice associated with any taxable transaction, while the latter is computed by applying the applicable VAT rate to the difference between a firm’s total sales and its total purchases (including the VAT element). In Kenya, the consumption type of computing VAT is mainly used.

2.3. VAT POLICY REFORMS

Since the introduction of VAT, there have been many policy changes. VAT was introduced as a multiple rate system with the standard rate of 18%. By 1991, the category of rates reduced from 15 to 8. To curb the inconveniences of operating a multiple tax rate system, the VAT rates were further reduced to 6 in 1992 and to 4 in 1993. In addition a restaurant and hotel tax rate of 5% was introduced effective 1st February 1993.

During the 1998/99 Budget, it was proposed that the VAT rate be reduced to 16% from 17%. To complete the process of simplifying VAT rate structure, the 1999/2000 budget proposed that the 12% rate increase to 15%, with exception of restaurant and accommodation service tax which were increased to 13% and 2% respectively thus forming a flat tax of 15% (GoK, 1999).

2 Budget Speeches of 1989/90 to 1992/93
A summary of the changes in the VAT rate is given in Table 2 below:

Table 2: Changes in VAT Rates

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<tr>
<td>Lower rate (%)</td>
<td>6</td>
<td>8</td>
<td>10/12</td>
<td>12</td>
<td>13</td>
</tr>
<tr>
<td>Standard rate (%)</td>
<td>15</td>
<td>15</td>
<td>16/17</td>
<td>16</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Budget Speeches various issues

The VAT registration threshold has also undergone several changes since the introduction of VAT. In 1991, the registration threshold was increased from the initial annual turnover of Kshs. 200,000 to 250,000. Taking into account the inflation rates, the 1994/95 budget proposed that the minimum turnover levels for compulsory registration be raised by Kshs. 300,000 per annum to Kshs. 900,000 for manufacturers and Kshs. 1,500,000 for other traders. However in the 1999/2000 budget, the need to prevent small businesses being caught up in registration costs and compliance problems saw the increase of the registration threshold to Kshs. 3.6 million up from Kshs. 2.4 million (GoK, 1999).

2.4. SECTORAL AND DISTRICT-WISE VAT COLLECTION

According to Mtatifikolo (1990), actual tax collection depends on two main factors. The actual or realizable economic surplus which determines what is available for taxation, and the mechanism or tax handles of the government which are associated with the ability of the government to extract the surplus. He adds that, at an early stage of economic development, the surplus (production net of consumption) is small, but as the economy expands there is a built in responsiveness of the tax system to the expansion in income and therefore a resultant increase in revenue.

Odd-Hedge (1995), points out that the gross tax revenue can rise if the rate of tax and legislation can be changed to raise more revenue from the base or if the base of tax grows. A combined effect of these two factors with respect to GDP is what is known as tax buoyancy. On the other hand, the amount by which revenue from a tax, with a given structure changes in response to a tax base is termed as the elasticity of the tax.

In Kenya today, VAT on local goods and services and on imports are administered by the VAT and Customs & Excise departments respectively. The VAT department has appointed the Central Bank of Kenya (CBK) as its main collection agent, and commercial banks in towns without a CBK branch.
Registered taxpayers file returns through the use of VAT 3 forms, and the returns must be submitted by the 20th day of the month following the transactions. The collected amounts are then remitted to the exchequer from the Commissioner of VAT’s account in CBK (GoK, 1999a).

Since the 1997/98 financial year, collections have been analyzed in terms of the VAT districts. They include: Nairobi East and West, Mombasa, Nakuru, Thika, Kisumu, Eldoret, Nyeri, Kakamega, Kisii, Embu, Machakos, Malindi/Kilifi, Kericho, Garissa, Large Tax Payers Office (LTO) and Bungoma3. Most revenue is collected from areas around the major towns in the country, with Nairobi contributing to about 60% of total domestic VAT revenue collection (KRA, 1999a). The formation of the Large Tax Payers Office in 1998 appeared to have been a step in the right direction as approximately 55% of the total collections of the department are raised from the top 200 taxpayers administered by the office.

Sectoral zoning of VAT began in 1999 to enable the department to quantify compliance. The sectoral collections are divided into 10 business sectors namely: agriculture, forestry & fishing, mining & quarrying, manufacturing, electricity, gas & water, construction, distributive trade, transport storage & communication, finance insurance, real estate & business, community, social & personnel services and other sectors not adequately defined. The manufacturing sector contributes about a half of the total VAT collections (MOFP, 1999b).

Of greater importance is the agriculture sector as the majority of the Kenyan population is engaged in it. In fact, the sector employs about 70% of the labour force and contributes to 25% of Kenya’s GDP (World Bank, 1997).

Transactions in this sector are however hard to observe and tax, and the only probable way to tax the small-scale farmers is through export taxes (Newbery, 1987:202). Hyden (1980) in addition, argues that, this is largely because tax on farm output may cause the small-scale farmers to withdraw from the market by resorting to subsistence farming.

As is the case of small scale and subsistence farming, it is generally difficult to tax small retail establishments, self-employed businessmen, professional and petty traders (Musgrave, 1990). The need to deal with a large number of taxpayers may result in heavy administrative costs, which may be larger than the amounts of revenue actually collected. Secondly, many of the traders may find it burdensome to maintain books of account and even if kept, tax officials have little evidence to judge their accuracy (Hyden, 1980).

3 The Garissa office was the most recently opened, on the 4th of May 1999.
According to Wagacha (1999), the informal sector (small scale sector) constitutes a significant share of many African economies – 67% of Uganda’s gross national product (GNP), 32.4% of the GNP in Ghana and 31.4% of GNP in Tanzania. In Kenya, the sector has expanded by over 70% in the past 6 years (GoK, 1996). Much of the activity of the sector is untaxed.

Bagachwa (1995) recommends that governments should come up with innovative ways of taxing the informal sector. Research attributes expansion of the sector to deregulation and liberalization of the economic systems and contributes the increased attempts to reduce costs by evading labour and tax regulations by the sector to increased competition. As is typical in Nairobi today, petty trading is partly explained by the fact that local businessmen transfer their trade from shops to the streets, thereby avoiding taxes and undermining the tax base.

The major parastatals in Kenya are potential revenue earners for the government, but have been in many instances caught up in huge debt hurdles. According to an article by Mbatai wa Ngai (1999), the KRA in March 1999, turned down the request by KP&TC for the waiver of a Kshs. 3 billion principal, and 10 billion debt in accrued interests and penalties. This was in the wake of the privatization process by the parastatal.

2.5. VAT EVASION AND EXEMPTIONS

A study by International Monetary Fund (1992), revealed that by imposing low taxes on mass consumption commodities, thereby taxing the informal sector indirectly in its consumption basket, total tax evasion by the sector can be reduced. This has been implemented in Senegal and Mauritania. The imposition of higher penalties and improvement of administration are other effective measures.

According to Odd-Helge (1995), the widespread effort to reform the tax structure by reducing the tax rates and abolishing tax exemptions is generally revenue neutral if fully implemented. While reducing rates usually meets few obstacles, removal of exemptions has at times been delayed or partially executed due to resistance by vested interests leading to unanticipated shortfalls in revenue.
Exemptions are usually granted to donor agencies, including foreign companies engaged by the donors. This has contributed to erosion of the tax base (Odd-Helge, 1995). The import and capital intensive technologies characterized by donor funded projects are indicators of distortions created by the tax-free status. Anecdotal evidence also indicates that foreign companies have ousted local companies through this kind of unfair competition. By 1992, at least two countries, Senegal and Togo had taken steps to eliminate tax exemptions related to bilateral and multilateral assistance by fully taxing capital imports financed from abroad and crediting donor accounts for the taxes paid (IMF, 1992). In Kenya, the VAT foregone through exemptions is about 3% of the total VAT collections (MOFP, 1999).
CHAPTER THREE
3.0. METHODOLOGY

3.1. DATA SOURCES

To achieve the objectives of this study, both primary and secondary data were used.

Primary data was collected through focused in-depth interviews with VAT officials and fact sheets were used to collect information on revenue sources.

To collect information on collections of VAT, target VAT revenues, collections in districts and sectors, records from the collection and computer departments of VAT were analyzed. Information was also collected from economic surveys and statistical abstracts.

3.2. SAMPLING PROCEDURES

For the purpose of accuracy of findings, the study was set for the period between the financial years 1994/95 to 1998/99. This was because prior to this period there was very little consistency in data collection and analysis, thus retrieving information was difficult.

The population of the study included the four departments of KRA: Customs & Excise, VAT, Income Tax and the Road Transport Departments. Specific emphasis was given to the VAT department as VAT was the main area of focus of the study.

To compare VAT revenues district-wise, data was collected from the following VAT districts: Nairobi East and West, LTO, Mombasa, Kakamega, Eldoret, Kisumu, Kericho, Thika, Nakuru, Nyeri, Kisii, Kilifi, Embu and Machakos and Garissa.

In terms of business sectors, revenues from the following business sectors were collected and analyzed: agriculture, forestry & fishing, mining & quarrying, manufacturing, electricity, gas & water, construction, distributive trade, transport storage & communication, finance insurance, real estate & business service, community, social & personal services and other sectors not adequately defined.
In comparison of total VAT to other tax revenue sources, the collection amounts considered were those paid to the exchequer, and the VAT collection includes both domestic and import VAT.

On the other hand, in the analysis of VAT according to business sectors and VAT districts, and in comparing actual and target VAT collections, only the domestic VAT collections were considered.

In addition, an in-depth focussed interview was conducted among five randomly selected VAT officials.

### 3.3. LIMITATIONS OF THE STUDY

During the course of the study, several limitations were encountered:

1. The period of the study was approximately ten weeks. The time was not adequate to conduct the study as extensively as would otherwise have been.
2. Some of the information required for the study was considered classified by the providers.
3. The zonal analysis of domestic VAT collections was intended to focus on the period between 1994/95 and 1998/99, but due to difficulty in obtaining some of the data, the analysis was for the period 1996/97-1998/99.
CHAPTER FOUR

4.0. ANALYTICAL FRAMEWORK

4.1. DEFINITION AND MEASUREMENT OF VARIABLES

4.1.1. Definition of Variables

Tax Collections: The actual receipts from taxpayers from different tax sources.

VAT: An indirect tax payable by the consumer, collected at all stages of value addition to products and services by the manufacturers, importers, distributors, wholesalers and retailers from the customer on behalf of the government.

Income tax: This is tax on revenues generated by businesses or persons (Moles & Terry, 1997:79).

Customs & Excise duty: Taxes levied on imports and exports.

Road transport duties: Charges from road licenses and PSV, driving licenses, TIR licenses, registration and transfer fees, second hand purchase taxes and road safety council fees.

Internal tax revenue: This refers to the total government revenue from income tax, VAT, customs and excise, road transport charges and other miscellaneous taxes.

GDP: A measure of the total flow of goods and services generated by an economy over a specified period of time, usually annually (Moles & Terry, 1997:262).

Actual VAT collections: The VAT collections received by the VAT department.

Target VAT collection: The planned VAT receipts.

VAT districts: Basic units of organization of Inland Revenue. The districts include: Nairobi East and West, Large taxpayers office, Mombasa, Kakamega, Eldoret, Kisumu, Kericho, Thika, Nakuru, Nyeri, Kisii, Kilifi, Embu, Machakos and Garissa.
Business sectors: These are sectoral classifications of the various economic activities such as: agriculture, hunting, forestry and fishing, mining and quarrying, manufacturing, electricity, gas and water, construction, distributive trade, transport, storage and communication, financing, insurance, real estate and business, community, social and personal services and other sectors not adequately defined.

4.1.2. Measurement of Variables

Table 3 below shows the list of variables used in this study and how their analysis was done.

Table 3: Measurement of Variables

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>MEASUREMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>-Total VAT collections</td>
<td>Relating VAT collections to the other revenue sources and thus determine</td>
</tr>
<tr>
<td>-Income tax collections</td>
<td>the degree of its importance as a source of ordinary revenue over time and</td>
</tr>
<tr>
<td>-Road transport collections</td>
<td>also determine the trend in reduction of direct taxation.</td>
</tr>
<tr>
<td>-Customs &amp; Excise collections</td>
<td></td>
</tr>
<tr>
<td>-Total VAT collections</td>
<td>Compare total VAT collections to the total tax collections, and GDP to VAT</td>
</tr>
<tr>
<td>-Total tax collections</td>
<td>growth rates over the period and thus establish the significance of VAT to</td>
</tr>
<tr>
<td></td>
<td>internal revenue.</td>
</tr>
<tr>
<td>-Actual domestic gross VAT collections</td>
<td>Compare actual and target collections to determine the extent to which the</td>
</tr>
<tr>
<td>-Target domestic gross target collections</td>
<td>Kenya Revenue Authority has achieved the objectives it set out to accomplish.</td>
</tr>
<tr>
<td>-VAT districts</td>
<td>Examine the VAT collection district wise to establish the major contributors.</td>
</tr>
<tr>
<td>-Gross domestic VAT collections</td>
<td></td>
</tr>
<tr>
<td>-VAT business sectors</td>
<td>Examine the VAT collections according to business sectors to establish the</td>
</tr>
<tr>
<td>-Gross domestic VAT collections</td>
<td>major contributing sectors.</td>
</tr>
</tbody>
</table>

4.2. DATA ANALYSIS

Data collected was computer formatted, coded and analyzed using Excel and SPSS statistical packages. The analysis was mainly descriptive using means, graphs, charts, tables to compare VAT collections to targets, other tax sources and the GDP in order to assess its significance to the economy and level of achievement of targets. The data was analyzed in aggregate to uphold confidentiality.
CHAPTER FIVE

5.0. STUDY FINDINGS AND CONCLUSION

In this section the study findings are presented in five sections in line with the study objectives. Specifically, the section analyzes total VAT collections as compared to other tax revenue sources, total tax and GDP. In addition there is analysis of gross domestic VAT collections by VAT districts and business sectors. To aid in this descriptive analysis, tables and graphs have also been used.

5.1. STUDY FINDINGS

5.1.1. Tax Revenue Collections

The main sources of tax revenue for the government include Income, Customs & Excise, VAT and road transport taxes. Any other taxes paid to the government are lumped up as ‘other taxes’ because their contributions are too small to be analyzed individually.

(a) Revenues from the different tax sources

The total tax collections from these tax revenue sources between 1994/95 and 1998/99, are summarized in Table 4 below.

Table 4: Revenues from the different taxes

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Tax Kshs. (000,000)</th>
<th>Customs &amp; Excise Kshs. (000,000)</th>
<th>VAT Kshs. (000,000)</th>
<th>Road Transport Kshs. (000,000)</th>
<th>Other Taxes Kshs. (000,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>43,505.80</td>
<td>37,930.40</td>
<td>24,533.80</td>
<td>426.00</td>
<td>1,714.60</td>
</tr>
<tr>
<td>1995/96</td>
<td>48,082.40</td>
<td>43,787.40</td>
<td>28,403.80</td>
<td>459.40</td>
<td>2,012.40</td>
</tr>
<tr>
<td>1996/97</td>
<td>48,375.00</td>
<td>46,281.20</td>
<td>29,850.00</td>
<td>718.60</td>
<td>1,804.40</td>
</tr>
<tr>
<td>1997/98</td>
<td>55,578.80</td>
<td>52,948.60</td>
<td>34,468.00</td>
<td>832.80</td>
<td>1,784.80</td>
</tr>
<tr>
<td>1998/99</td>
<td>58,535.80</td>
<td>56,099.20</td>
<td>37,935.40</td>
<td>869.80</td>
<td>1,767.40</td>
</tr>
</tbody>
</table>

Source: Economic surveys (various issues)

---

4 A description of the taxes is provided in chapter 4.
5 The revenue amounts used are those paid to the exchequer, and the VAT amounts are the ‘total VAT’, which includes both domestic and import VAT.
A graphical presentation of Table 4 is provided in Figure 1 above.

It can be clearly seen that income tax remains the highest revenue generator for the government, followed by customs and excise, VAT, then lastly, road transport taxes\(^6\).

In the 1998/99 FY, revenues from income tax, customs and excise, VAT and road transport were 58, 56, 37 and 0.869 million respectively.

This clearly indicates that income tax is the highest source of tax revenue due to its nature as a direct tax source and ease in collection. The main forms of income tax include corporate taxes and Pay As You Earn (P.A.Y.E.).

\(^6\) As a KRA department, Customs & Excise collects the highest amount of gross taxes, but some money collected by the department does not go directly to the exchequer but to other government agencies. For instance, the road maintenance levy of approximately Kshs.1 billion per year goes to the Ministry of Public Works.
Kenya being primarily an agricultural nation relies heavily on imports of goods of various nature in order to sustain her industries. This accounts for the high amounts of Custom & Excise taxes revenue compared to VAT. The increase in number of vatable goods and services over the period has led to rise in VAT collections.

Road transport taxes contribute the least to the exchequer. According to KRA management, this can be partly attributed to the mushrooming of illegal ‘downtown’ registration centres. The department is more of a service department than a tax maintenance department. It mainly works closely with the other KRA departments to ensure that tax evasion is minimized. For instance, for a vehicle to be registered by the department, they first ensure that all import duties have been paid. Similarly, before they issue a ‘matatu’ with the TLB license they ensure that the advance tax on the vehicle has been paid.

Figure 1 also shows that there has been a steady rise in revenue collections as a whole between 1994 and 1999, although there was a marked period of slow growth in VAT revenue during the 1995/96 FY.

The steady rise in revenues can be attributed to the inception of the tax collection body, KRA, in 1995, which gave impetus to revenue collection. Better pay of staff and promotions of technical staff acted as incentives towards better work delivery. As a result, work became more organized and new programmes such as default monitoring and taxpayer services and education, enhanced taxpayer compliance.

(b) Changes in total VAT revenues

In terms of changes in VAT revenues over the years, there was a 15% rise in VAT revenues between 1994/95 and 1995/96. This dropped to a 5% rise between 1995/96 and 1996/97 then rose again to 15% in the next period, finally settling to a 10% increase between 1997/98 and 1998/99.
In summary, as indicated in Table 5 below, there has been a wave like trend in the increase of VAT revenues during the period.

**Table 5: Changes in VAT revenue (1994/95 - 1998/99)**

<table>
<thead>
<tr>
<th>PERIOD</th>
<th>PERCENTAGE INCREASE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95 - 95/96</td>
<td>15</td>
</tr>
<tr>
<td>1995/96 - 96/97</td>
<td>5</td>
</tr>
<tr>
<td>1996/97 - 97/98</td>
<td>15</td>
</tr>
<tr>
<td>1997/98 - 98/99</td>
<td>10</td>
</tr>
</tbody>
</table>

The high increase in VAT revenues in the 1994/95 financial year was mainly due to the inception of the VAT department.

According to VAT department management, the marked period of slow growth in VAT during the 1995/96 financial year can be attributed to the onset of the elections period, which resulted in reduction of imports due to uncertainties of the traders. In addition, there was high inflation leading to reduced consumption by individuals and firms.

The general decline in percentage increase in revenue between 1997/98 – 1998/99 on the other hand, was due to the stabilization effect that came along with implementation of the VAT department policies in VAT administration.

(c) *Comparison of direct and indirect taxes for the period 1994/95 – 1998/99*

In analyzing revenues in terms of direct and indirect taxes, the survey revealed that there was an increase in indirect taxes and a decrease in direct taxes as shown in Table 6 below.

**Table 6: Changes in the revenues from various taxes (1994/95 - 1998/99)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Tax</th>
<th>Customs &amp; Excise</th>
<th>VAT</th>
<th>Road Transport &amp; Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>40%</td>
<td>35%</td>
<td>23%</td>
<td>2%</td>
</tr>
<tr>
<td>1998/99</td>
<td>38%</td>
<td>36%</td>
<td>24%</td>
<td>2%</td>
</tr>
<tr>
<td>Increase/Decrease</td>
<td>-2%</td>
<td>1%</td>
<td>1%</td>
<td>-</td>
</tr>
</tbody>
</table>
As can be seen in Figures 2 and 3 below, income tax in the 1994/95 financial year, contributed the highest revenue to the tax pool, and retained this position by the end of the 1998/99 financial year although its contribution decreased by 2%. This can be attributed to the gradual widening of the income tax bracket and lowering of the rates, in line with the government policy to shift from direct to indirect taxation. This for instance led to a reduction of corporate tax from 65% in 1988 to the current 30%.

**Figure 2: Comparison of revenues from the various taxes in the 1994/95 FY**

![Pie chart showing revenue distribution in 1994/95](image)

**Figure 3: Comparison of revenues from various taxes in the 1998/99 FY**

![Pie chart showing revenue distribution in 1998/99](image)
Total VAT collections on the other hand, increased by 1% during the period. This according to the VAT management is attributed to the reduction in VAT rates to the current 15%. The increase is also due to broadening of the VAT base which had the effect of increasing the number of registered taxpayers to 21,500 million in 1995/96 FY to 26,000 million in the 1999/00 FY.

In addition to this, the VAT department has undertaken steps in order to improve taxpayer education, which has consequently improved the level of compliance. Taxpayer education efforts have been through workshops organized and mainly targeted at the newly registered firms. The department has also acquired a web site (http://www.revenue.go.ke), which makes its information more accessible to the public.

5.1.2. VAT Revenue Contribution to Total Internal Government Revenue

The VAT contribution as a source of internal revenue during the period 1994/95 - 1998/99 has been varying as summarized in Table 7 below.

Table 7: VAT as Percentage of Total Tax Revenue

<table>
<thead>
<tr>
<th>YEAR</th>
<th>VAT KSHS. (000,000)</th>
<th>TOTAL TAX KSHS. (000,000)</th>
<th>VAT/TOTAL TAX KSHS. (000,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>24,533.80</td>
<td>108,111.00</td>
<td>22.6%</td>
</tr>
<tr>
<td>1995/96</td>
<td>28,403.80</td>
<td>122,745.00</td>
<td>23.1%</td>
</tr>
<tr>
<td>1996/97</td>
<td>29,850.00</td>
<td>127,029.00</td>
<td>23.3%</td>
</tr>
<tr>
<td>1997/98</td>
<td>34,468.00</td>
<td>145,612.00</td>
<td>23.7%</td>
</tr>
<tr>
<td>1998/99</td>
<td>37,935.40</td>
<td>155,208.00</td>
<td>24.4%</td>
</tr>
</tbody>
</table>

Source: VAT department

VAT contribution to the total tax revenue pool increased from 22.6% in the 1994/95 financial year, to 24.4% in the 1998/99 financial year. This increase can be attributed to improved VAT administration. It is also an indication that VAT is the tax of the future, as the government shifts away from direct to indirect taxes.
5.1.3. Contribution of VAT Revenue to Kenya’s GDP

Table 8 below shows the contribution of VAT revenue to Kenya’s GDP between 1994/95 and 1998/99.

Table 8: VAT Revenue Contribution to GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP (at market prices) Kshs.( 000,000)</th>
<th>Total VAT Kshs.( 000,000)</th>
<th>Percentage contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>433,200</td>
<td>24,500</td>
<td>5.65</td>
</tr>
<tr>
<td>1995/96</td>
<td>496,800</td>
<td>28,400</td>
<td>5.74</td>
</tr>
<tr>
<td>1996/97</td>
<td>563,900</td>
<td>29,900</td>
<td>5.25</td>
</tr>
<tr>
<td>1997/98</td>
<td>636,620</td>
<td>34,500</td>
<td>5.41</td>
</tr>
<tr>
<td>1998/99</td>
<td>698,000</td>
<td>38,000</td>
<td>5.44</td>
</tr>
</tbody>
</table>

Source: VAT Department

From Table 8 it can be seen that the contribution of total VAT to GDP rose from 5.67% in 1994/95 to 5.74% in 1995/96. There was a drop in contribution to 5.25% in 1996/97, while the subsequent year saw a rise in contribution from 5.41% in 1997/98 to 5.44% in 1998/99. The drop in the VAT contribution in 1996/97 is attributed to ineffective VAT administration during the period.

In terms of growth rates VAT as a consumption tax is expected to have a positive relationship to the country’s GDP\(^7\). As GDP increases consumption of goods and services is expected to grow accordingly, and therefore growth in VAT revenue.

\(^7\) GDP is a country’s income from internal sources. An increase in GDP generally results in increased incomes of the masses, which in turn increases purchasing power and consumption.
Table 9 below shows the growth rates of GDP and VAT between 1994/95 and 1998/99.

Table 9: GDP and Total VAT Growth Rates

<table>
<thead>
<tr>
<th>FY</th>
<th>GDP GROWTH RATE</th>
<th>VAT REVENUE GROWTH RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>3%</td>
<td>28.9%</td>
</tr>
<tr>
<td>1995/96</td>
<td>4.8%</td>
<td>15.5%</td>
</tr>
<tr>
<td>1996/97</td>
<td>4.6%</td>
<td>5.3%</td>
</tr>
<tr>
<td>1997/98</td>
<td>2.3%</td>
<td>15.4%</td>
</tr>
<tr>
<td>1998/99</td>
<td>1.8%</td>
<td>12.8%</td>
</tr>
</tbody>
</table>

Source: VAT department

It can be observed from the table that there is a direct relationship between GDP and VAT growth rates as they have both decreased during the period 1994/95 and 1998/99. GDP growth rate reduced from 3% in 1994/95 to 1.8% in 1998/99, while VAT revenue growth rate reduced to 12.8% from 28.9% in the same period.

The direct relationship between the two growth rates is however not reflected in some financial years. For example, between the financial years 1995/96 and 1996/97, the GDP growth rate reduced marginally from 4.8% to 4.6%, while VAT revenue growth rate reduced by a bigger proportion for 15.5% to 5.3%. This can largely be attributed to lack of effective VAT administration at the time leading to underutilized VAT potential. Improved VAT administration in 1997/98 led to growth of VAT revenues from 15.4% from 5.3% in 1996/97 despite the fact that GDP growth rate reduced to 2.3% from 4.6% during the same period.

5.1.4. VAT Targets

According to the VAT department’s Management, Exchequer VAT collection targets\(^8\) are set by the Ministry of Finance and communicated to the KRA. However, to set the gross VAT collection targets, the department adds what it intends to pay as refunds to the exchequer target. In addition, the department in conjunction with treasury works out the monthly seasonality of the annual exchequer target. In this way the two are able to agree on the monthly targets. It is worth noting that in the course of the FY the Ministry of Finance can revise upwards or downwards the revenue targets depending on the performance of the economy or the requirements of the exchequer.

\(^8\) The Ministry of Finance sets the targets for what is due to the exchequer in a given year.
(a) Exchequer Targets

Table 10: Domestic VAT payments to the Exchequer

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Actual VAT collections Kshs. (000,000)</th>
<th>Target VAT collections Kshs. (000,000)</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996/97</td>
<td>14,800</td>
<td>15,600</td>
<td>(800)</td>
</tr>
<tr>
<td>1997/98</td>
<td>19,200</td>
<td>18,200</td>
<td>1,000</td>
</tr>
<tr>
<td>1998/99</td>
<td>21,100</td>
<td>21,000</td>
<td>100</td>
</tr>
<tr>
<td>1999/00</td>
<td>14,700</td>
<td>14,400</td>
<td>300</td>
</tr>
<tr>
<td>July'99 to Feb'00</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: VAT department

It is clear from Table 10 that the VAT department has been able to achieve the exchequer\textsuperscript{9} targets since the 1997/98 financial year.

However, according to VAT department Management the high shortfall in the 1996/97 can be attributed to the diversion of funds to pay the refunds claims backlog, and the fall in arrears revenues due to decrease in arrears received from parastatals, that was experienced in that period.

The high positive variance registered in 1997/98 was due to restructuring of the department into VAT districts and change of management. This was a ‘one-off’ situation that resulted in windfall gains on collections, but the situation has since stabilized as indicated by the variances of the subsequent years.

\textsuperscript{9} Actual exchequer remittance refers to net collections after target refunds and bank charges have been deducted.
(b) Gross VAT Targets

Between the 1994/95 and 1998/99 financial years, there was a marked variance between the target VAT collections set by the VAT department and the actual domestic VAT collections as shown by Table 11.

Table 11: The Actual, Target and Variance of Domestic Gross VAT Collections

<table>
<thead>
<tr>
<th>Year</th>
<th>Target domestic gross VAT collections KSHS. (000,000)</th>
<th>Actual domestic gross VAT collections KSHS. (000,000)</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994/95</td>
<td>-</td>
<td>15,600</td>
<td>-</td>
</tr>
<tr>
<td>1995/96</td>
<td>17,000</td>
<td>16,100</td>
<td>(900)</td>
</tr>
<tr>
<td>1996/97</td>
<td>19,200</td>
<td>18,500</td>
<td>(600)</td>
</tr>
<tr>
<td>1997/98</td>
<td>22,300</td>
<td>22,100</td>
<td>(200)</td>
</tr>
<tr>
<td>1998/99</td>
<td>24,000</td>
<td>23,800</td>
<td>(200)</td>
</tr>
</tbody>
</table>

Source: VAT department

Figure 4: The Actual and Target Domestic Gross VAT Collections (1994/95 – 1998/99)
From Figure 4 above it can be observed that, there has always been a variance between the actual and target gross domestic VAT collections10. More impressive, the gap appears to have been narrowed over the period 1994/95 to 1998/1999.

This is unlike the exchequer targets where the department has been able to meet targets because priority is usually given to the exchequer other than taxpayers to be refunded. It is worth noting that, the gross VAT revenue target includes what the department intends to refund the concerned taxpayers. Therefore, the negative variances indicate that the department does not raise enough money to meet the exchequer target and settle the outstanding refund claims and bank charges.

Reasons for the negative variance according to the VAT Management include: the presence of inadequate capital and human resources, non-compliance by tax payers due to various factors including political patronage, non-delivery of services by the government, and corruption amongst staff and taxpayers. In addition, the attitudes towards payment of taxes by taxpayers, and the general poor economic performance of the economy, contribute to the negative variances.

On the other hand, the decline in variance between the financial years 1996/97 and 1997/98 is attributed to the change in management and restructuring of the VAT department, which fostered more efficient VAT administration. Other factors include: broadening of the VAT tax base, reduction in VAT rates to the current level of 15%, which enhanced compliance and taxpayer education, increased staff motivation, and intensified debt collection efforts.

However, it can be observed that the negative variances have steadily been declining since 1996/97. This stability can be attributed to the factors above as well as sector-wise zoning that was introduced during the period to quantify the actual compliance rates.

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10 Domestic gross VAT collections refers to the total amount collected by the VAT department from taxpayers before target refunds and bank charges are settled.
5.1.5. Domestic Gross VAT Collections by VAT Districts

Table 12: Domestic Gross VAT revenue collections by VAT Districts\textsuperscript{11} (1996/97-1998/99)

<table>
<thead>
<tr>
<th>DISTRICTS</th>
<th>1996/97 KSHS. (000,000)</th>
<th>1997/98 KSHS. (000,000)</th>
<th>1998/99 KSHS. (000,000)</th>
<th>MEAN KSHS. (000,000)</th>
<th>PERCENTAGE CONTRIBUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>LARGE TAX PAYERS OFFICE</td>
<td>8,168.00</td>
<td>8,808.00</td>
<td>8,278.00</td>
<td>8,416</td>
<td>50.21</td>
</tr>
<tr>
<td>NAIROBI WEST</td>
<td>2,653.00</td>
<td>3,334.00</td>
<td>3,833.00</td>
<td>3,273</td>
<td>19.53</td>
</tr>
<tr>
<td>NAIROBI EAST</td>
<td>1,947.48</td>
<td>2,320.00</td>
<td>2,664.00</td>
<td>2,310</td>
<td>13.78</td>
</tr>
<tr>
<td>MOMBASA</td>
<td>1,286.40</td>
<td>749.10</td>
<td>1,408.58</td>
<td>1,148</td>
<td>6.85</td>
</tr>
<tr>
<td>THIKA</td>
<td>471.18</td>
<td>503.36</td>
<td>513.82</td>
<td>496</td>
<td>2.66</td>
</tr>
<tr>
<td>NAKURU</td>
<td>293.80</td>
<td>223.84</td>
<td>306.75</td>
<td>291</td>
<td>1.60</td>
</tr>
<tr>
<td>KERICHO</td>
<td>221.38</td>
<td>266.82</td>
<td>251.14</td>
<td>253</td>
<td>1.51</td>
</tr>
<tr>
<td>MACHAKOS</td>
<td>117.22</td>
<td>150.29</td>
<td>206.87</td>
<td>158</td>
<td>0.94</td>
</tr>
<tr>
<td>NYERI</td>
<td>127.13</td>
<td>137.53</td>
<td>151.41</td>
<td>139</td>
<td>0.83</td>
</tr>
<tr>
<td>KISUMU</td>
<td>74.66</td>
<td>94.80</td>
<td>119.16</td>
<td>96</td>
<td>0.57</td>
</tr>
<tr>
<td>ELDORET</td>
<td>74.03</td>
<td>96.09</td>
<td>98.72</td>
<td>90</td>
<td>0.53</td>
</tr>
<tr>
<td>KILIFI</td>
<td>43.68</td>
<td>31.91</td>
<td>29.54</td>
<td>35</td>
<td>0.21</td>
</tr>
<tr>
<td>EMBU</td>
<td>16.99</td>
<td>28.28</td>
<td>25.18</td>
<td>23</td>
<td>0.14</td>
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<tr>
<td>KAKAMEGA</td>
<td>10.98</td>
<td>11.75</td>
<td>13.53</td>
<td>12</td>
<td>0.07</td>
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<tr>
<td>KISII</td>
<td>9.34</td>
<td>8.43</td>
<td>12.13</td>
<td>10</td>
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<tr>
<td>GARISSA</td>
<td>0.18</td>
<td>1.80</td>
<td>0.59</td>
<td>1</td>
<td>0.01</td>
</tr>
</tbody>
</table>

Source: VAT Department

From Table 12 above it can be observed that the percentage contribution of the domestic Vat revenue is dependent on the economic potential of various regions of the country. The well-to-do regions contribute higher VAT revenues compared to others that are less endowed.

In addition, it can also be observed that the Large Taxpayers Office is the largest contributor, contributing an average of 50.21% of the mean VAT collections during the period. This is mainly because the district consists of the first 200 highest taxpayers from all over the country. According to the VAT management, the compliance rate is higher among the Large Taxpayers, as the cost of compliance is usually less than the cost of non-compliance. Some of the firms in this district include, East African Breweries Ltd., British American Tobacco (BAT) and most parastatals such as Telkom Ltd., Kenya Power and Lighting Company (KP&LC), Kenya Railways etc.

\textsuperscript{11} A VAT district refers to the actual district named as well as its environs.
Nairobi West district consists of areas West of Nairobi including Nairobi's industrial area, while Nairobi East covers mainly the town centre where most businesses are mainly service oriented for instance, supermarkets, hotels, law firms etc. Jointly, the two areas contributed 33.31% on average during this period. Their contributions can be attributed to the large number and quality of taxpayers in the area, the accessibility of the VAT administrators to the area, and the economic potential of the area, which is higher than the other districts.

Mombasa is the hub of the tourism industry in Kenya and consequently, the fourth largest contributor of gross domestic VAT revenue. Hotels and related industries alone account for over 90% of the total VAT collections from the region.

From Table 12 it is clear that, there was a marked reduction in domestic VAT collections from the district during the 1997/98 FY. According to VAT department management, this can be attributed to the ethnic clashes that occurred in the region thereby creating general insecurity. The recurrent clashes together with poor infrastructure led to decline in the tourism industry.

Thika, Kericho and Nakuru are rich agricultural areas, and therefore the populations in these areas have a relatively higher purchasing power. As VAT is a tax on consumption, VAT revenue contributions of a region are dependent on the purchasing power of its population.

Though it is an agriculturally rich region, Eldoret is an exception to the above rule as a large gap exists between the rich and the poor. It is therefore expected that most of the rich consume vatable goods, while most of the poor may consume non-vatable goods. In addition, there is possibility that there is potential that is underutilized in the region as far as VAT is concerned.

Though Kisumu is the third largest town in Kenya, its population is relatively poor. Most industries that formally thrived in the area like textile, sugarcane and fishing have declined. This explains why the contribution in the area is minimal.
The region around Garissa contributed the lowest in terms of VAT collections during the period. This can be largely attributed to the fact that the inhabitants of the area are mainly nomads. In addition, poor infrastructure in the region makes accessibility impossible and the area to be covered by the VAT officers is too large considering that there is lack of adequate transport and armed escorts in the bandit areas. The Garissa District office was opened mainly to curb smuggling of goods from Somalia and other neighbouring countries.

In general, there has been a marked increase in the VAT collections from the lesser contributing districts during the 1998/97 and 1998/99 FYs. This can be largely attributed to the increased administrative efforts of the VAT department. There has been more efficient deployment of personnel to these districts to monitor VAT collection. The opening of new offices has also brought services closer to the taxpayers thereby reducing their costs of compliance.

5.1.6. Domestic Gross VAT Collections by Business Sectors

The business sectors that mainly contribute to gross domestic VAT revenue include manufacturing, distributive trade and finance, insurance & personal services. The manufacturing sector alone contributed approximately half of the average collections for the period 1996/97 to 1998/99 as shown in Table 13 below. On the other hand, the distributive trade sector contributed 23% while the finance sector contributed 11%.

Table 13: Mean VAT Revenue Collections by Business Sectors (1996/97 - 1998/99)

<table>
<thead>
<tr>
<th>BUSINESS SECTORS</th>
<th>1995/97 KSHS. (000,000)</th>
<th>1997/98 KSHS. (000,000)</th>
<th>1998/99 KSHS. (000,000)</th>
<th>MEAN KSHS. (000,000)</th>
<th>PERCENTAGE CONTRIBUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>MANUFACTURING</td>
<td>7,423,808</td>
<td>8,676,147</td>
<td>8,462,500</td>
<td>8,250,752</td>
<td>48.8329</td>
</tr>
<tr>
<td>DISTRIBUTIVE TRADE</td>
<td>3,817,476</td>
<td>3,557,111</td>
<td>3,790,936</td>
<td>3,855,174</td>
<td>22.8172</td>
</tr>
<tr>
<td>FINANCE, INSURANCE, REAL ESTATE &amp; BUSINESS SERVICES</td>
<td>1,566,391</td>
<td>1,865,429</td>
<td>2,169,206</td>
<td>1,887,009</td>
<td>11.0501</td>
</tr>
<tr>
<td>TRANSPORT, STORAGE &amp; COMMUNICATION</td>
<td>641,792</td>
<td>1,085,581</td>
<td>1,033,802</td>
<td>921,725</td>
<td>5.4553</td>
</tr>
<tr>
<td>ELECTRICITY, GAS &amp; WATER</td>
<td>825,369</td>
<td>625,166</td>
<td>896,936</td>
<td>783,180</td>
<td>4.6352</td>
</tr>
<tr>
<td>CONSTRUCTION</td>
<td>370,034</td>
<td>414,257</td>
<td>488,350</td>
<td>424,560</td>
<td>2.5128</td>
</tr>
<tr>
<td>COMMUNITY, SOCIAL &amp; PERSONAL SERVICES</td>
<td>353,498</td>
<td>304,592</td>
<td>300,066</td>
<td>302,729</td>
<td>1.7917</td>
</tr>
<tr>
<td>SECTORS NOT ADEQUATELY DEFINED</td>
<td>222,855</td>
<td>265,754</td>
<td>270,771</td>
<td>253,061</td>
<td>1.4978</td>
</tr>
<tr>
<td>MINING &amp; QUARRYING</td>
<td>200,418</td>
<td>246,460</td>
<td>266,247</td>
<td>237,708</td>
<td>1.4059</td>
</tr>
<tr>
<td>AGRICULTURE, HUNTING, FORESTRY &amp; FISHING</td>
<td>10</td>
<td>7</td>
<td>13</td>
<td>10</td>
<td>0.0001</td>
</tr>
</tbody>
</table>

Source: VAT department

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12 Refer to appendix 2 for the sub sectors of the major business sectors.
The manufacturing sector is the main contributor of gross domestic VAT revenue as most of the largest taxpaying companies are in this sector. In addition, most of the goods consumed by the population are the products of this sector.

The distributive trade sector contributed averagely 22.8% to the VAT collections during the period. The sector includes sub sectors like retailing and wholesaling, which consists of businesses like supermarkets and other shops. Most goods and services of this sector are vatable, nevertheless it is a sector with rampant VAT evasion.

The finance, insurance, real estate and business services sector is the third largest gross domestic VAT contributor, with an average of Kshs. 1.9 billion (11%) per year to the total gross domestic VAT collections. Most financial services are non-vatable. On the other hand, the real estate sub sector is faced with increased cases of VAT evasion. The department does not have enough capacity to enforce compliance adequately in this sector.

The communication sub-sector is the main contributor of revenue to the transport and communication sector. According to Table 13, there has been a steady rise in terms of the VAT collections between 1995 and 1999. This is largely attributed to the increased privatization in this sector and enhanced service delivery. However, the potential of this sector is not fully realized as the highest taxpayers like the former K.P & T.C. are among the largest defaulters.

Within the electricity, gas and water sector, some of the highest taxpayers include Kengen and Kenya Power & Lighting Company. Poor weather conditions prevailing in the country leading to lower rainfall have contributed to the low revenue levels. During the period, so much revenue was lost in unsold power units due to power rationing. In addition, most of the industries have been forced to operate below capacity due to inadequate power provision.

Construction is a sector with the highest level of political interference. This has resulted in the decrease in gross domestic VAT collections, as there is increased VAT evasion because some operators in the government provide ‘protection’ to those contractors it provides with tenders. In addition, the government in many cases takes very long to pay the contractors and thus, the firms have not been able to settle their tax dues on time. Therefore most of the operators in this industry are defaulters.
Although agriculture contributes to 25% of Kenya’s GDP, transactions from the sector are difficult to tax. This is because 80% of the sector belongs to small-scale holders, who do not keep any accounting records. In addition, most agricultural exports such as tea are zero-rated and therefore are not taxed, and instead receive VAT refunds for the inputs purchased during the process. This is part of the government’s deliberate policy to make Kenya’s exports competitive abroad.
5.2. CONCLUSIONS

The study reveals that, though income tax and customs duties remain the highest tax revenue earners for the government, their contribution is declining. Currently, VAT is the third largest contributor to the tax revenue pool and its contributions have been on the increase since 1994/95. This state of affairs can be attributed to the government’s policy of shifting away from direct to indirect tax such as VAT. In addition, the implementation of the World Trade Organization (WTO) regulations, and formation of regional trade blocks such as the Common Markets For East and Central Africa (COMESA) and the East African Corporation (EAC), have led to decline of custom duties.

The contribution of VAT to the total tax pool increased from 22.6% in the 1994/95 FY to 24.4% in the 1998/99 FY. This has been due to better administration and widening of the VAT base. In addition, the VAT revenue contribution to GDP rose from 5.25% in 1996/97 to 5.44% in 1998/99, and it was established that generally, there is a positive relationship between GDP and VAT growth rates. However, the direct relationship between the two growth rates is not reflected in some financial years, implying that there is still a lot of VAT potential to be tapped.

Exchequer VAT targets set by the Ministry of Finance have been achieved and surpassed by the VAT department since 1997/98. However, the domestic gross VAT targets have generally not been achieved, mainly due to lack of adequate resources. Therefore, the department has not generated enough to pay the exchequer and settle refund claims, as priority is given to the exchequer compared to taxpayers refund claims. However, the variances have declined drastically since 1997/98. This was mainly due to better administrative measures by the VAT department.

In terms of VAT districts, the percentage contribution of the domestic VAT revenue is dependent on the economic potential of the various regions of the country. Well-to-do regions contribute higher VAT revenues compared to the ones that are less endowed. The Large Taxpayer Office, East and West of Nairobi districts contribute over 80% of the total VAT revenue.

In terms of business sectors, the manufacturing sector leads in contribution to the VAT pool, contributing about 50%. The distributive trade and financial sectors jointly contribute over 30% of domestic VAT. The transport and communication sector contributions have generally been rising during the period 1996/97-1998/99, due to increased privatization and efficiency of operations. The construction sector on the other hand, has a lot of potential in VAT but there is a lot of tax evasion.
The major obstacles to effective VAT administration were found to include: the lack of resources on the part of the VAT department, inadequate education of the taxpayers, VAT evasion, political interference, poor infrastructure and the general poor state of the Kenyan economy.

In conclusion, the continued growth of the VAT revenues over the years confirms the significance of VAT collections as a source of government revenue. However, more resources should be diverted to harnessing the large potential on VAT as an internal source of tax revenue.
6.0. RECOMMENDATIONS AND AREAS FOR FURTHER RESEARCH

6.1. RECOMMENDATIONS

In light of the study findings, the following are the recommendations.

- To increase the level of VAT collections, taxpayer education should be intensified. This is because tax compliance is generally related to the general feeling of the citizen vis-à-vis the state. In addition to the current programs at hand, more effort should be put to impart a feeling of conscious responsibility to the population at large. Thus, this education must start as early as possible preferably at school level in the curricula.

- The VAT personnel should be trained on the relevant computer skills and customer philosophy. This would enable them to check on tax evasion, as they would be enlightened on the various company systems. In addition, as most staff in the department are former civil servants, the need to train them on customer service need not be emphasized.

- The government should encourage the efforts of VAT department and KRA as a whole, by allocating more funds to enable adequate financing of operations. This would ensure that (i) the present personnel are adequately remunerated, (ii) additional qualified personnel are sourced and maintained, (iii) resources such as vehicles and security are attainable to enhance VAT administration and (iv) information technology is efficient.

- The issue of tax exemptions should be reviewed, as they are now a conduit of tax evasion, and thus a source of revenue leakage. VAT refunds should also be reviewed as they encourage fraud on the part of the businessmen. In addition, zero-rating of goods should be done away with and the government should promote the goods by applying other subsidies.

- The current registration threshold of Kshs. 3.6 million leaves out many small traders who are potential VAT payers, it should therefore be lowered to accommodate more traders.
- To net most businesses in the formal sector into the tax bracket, KRA should be made the sole licensing agent. KRA should then come up with a form of advance tax to be paid before any licensing of businesses is done.

- To promote voluntary compliance to VAT payment, the government should improve the infrastructure. This will be a start at restoring public confidence in the efficient use of tax revenue. In addition, the poor state of roads among other infrastructure has made the work of KRA very difficult. In line with this, the government’s interference in VAT administration should be minimized and KRA should be given a free hand in the tax affairs under its jurisdiction.
6.2. AREAS FOR FURTHER RESEARCH

The following areas are recommended for further study:

1. The extent to which the taxpayer population understands VAT and other tax issues.
2. VAT evasion and avoidance in Kenya.
3. Sectoral compliance to VAT.
4. Taxation of the informal sector in Kenya.
5. The effectiveness of VAT education on compliance.
APPENDIX I

INTERVIEW GUIDE

INTRODUCTION

I am a graduate student in Finance at the United States International University Africa. As part of my program, I am carrying out a research on the significance of Value Added Taxation to the Kenyan Government.

The data generated will promote more in-depth information necessary for my project paper.

To uphold confidentiality, all data obtained will be analyzed in aggregate.

Your co-operation in answering the questions and/or filling out the attached fact sheet will be highly appreciated.

Yours,

Risper D.N. Alaro
PROJECT TITLE:

THE SIGNIFICANCE OF VALUE ADDED TAX AS A SOURCE OF REVENUE FOR THE KENyan GOVERNMENT:

A CASE STUDY OF SELECTED VAT DISTRICTS AND BUSINESS SECTORS

OBJECTIVES OF THE STUDY

The general objective of the study is to establish the significance of VAT as a source of internal tax revenue for the Kenyan government. The period of study lies between the financial years 1994/95 and 1998/99.

The specific objectives are:

1. To determine the trends in total VAT revenue collections vis-à-vis other tax revenue sources.
2. To compare total VAT collections to total tax revenue collections and VAT growth rate to the gross domestic product (GDP) growth rate, thus establish its contribution to internal revenue.
3. To compare and analyze the trends in domestic VAT collections and targets of the same in order to establish the variance.
4. To establish and analyze the various sources of domestic VAT revenue collections that is, by VAT districts and business sectors.
5. To make recommendations in the light of the study findings.
INTERVIEW QUESTIONS

1. Can you explain the trends in VAT collections between the financial years (1994/95 - 1998/99)?

2. What have been the major obstacles faced in VAT collection?

3. How are VAT targets set, and what measures has the VAT department put forth to aid in achieving these targets?

4. What are the major obstacles faced by the department in achieving these targets?

5. What has the VAT department done to minimize VAT evasion?

6. In your view, to what extent has VAT become a significant source of government revenue?
## FACT SHEET
### DOMESTIC GROSS VAT REVENUE COLLECTIONS

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<thead>
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<th></th>
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<td>Large Taxpayers Office</td>
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<tr>
<td>Nairobi East</td>
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<td>Nairobi West</td>
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<td>Thika</td>
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**BUSINESS SECTORS**

- Manufacturing
- Distributive trade
- Finance, insurance, real estate and business services
- Transport, storage and communication
- Electricity, gas and water
- Construction
- Community, social and personal services
- Mining and quarrying
- Agriculture, hunting, forestry and fishing
- Sectors not adequately defined
APPENDIX II

MAJOR GROUPS WITHIN THE INTERNATIONAL STANDARDS OF INDUSTRIAL CLASSIFICATIONS

1. AGRICULTURE, HUNTING, FORESTRY AND FISHING
   1.1. Agriculture and Hunting
   1.2. Forestry and Logging
   1.3. Fishing

2. MINING AND QUARRYING
   2.1. Coal Mining
   2.2. Crude Petroleum and Natural Gas Production
   2.3. Metal Ore Mining
   2.4. Other Mining

3 MANUFACTURING
   3.1. Food, Beverages and Tobacco
   3.2. Textile, Weaving Apparel and Leather Industries
   3.3. Wood and Woodarts including Furniture
   3.4. Paper and Paper Products, printing and Publishing
   3.5. Chemicals and Chemical Products, Petroleum, Coal, Rubber & Plastics
   3.6. Non-metallic Mineral Products except Products of Petroleum and Coal
   3.7. Basic Metal Industries
   3.8. Fabricated Metal products, Machinery and Equipment
   3.9. Other Manufacturing Industries

4 ELECTRICITY, GAS AND WATER
   4.1. Electricity, Gas and Steam
   4.2. Water Works and Supply

5 CONSTRUCTION
   5.0. Construction
   5.1. Sites Preparation
   5.2. Building of Complete Structures of Parts thereof: Civil Engineering
   5.3. Building Installation
   5.4. Building Completion
   5.5. Other Building Completion

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6 DISTRIBUTIVE TRADE

6.1. Sale, Maintenance and repair of Motor Vehicles and Motor Cycles
6.2. Wholesale trade – on fee contract basis, of agricultural raw materials and live animals, food, beverage and tobacco, household goods, non-agricultural intermediate products, waste and scrap, machinery, equipment and supplies, other wholesale
6.3. Retail trade – except of motor vehicles and motor cycles and repair of personal and household goods, of beverages and tobacco in specialized stores, of pharmaceutical and medical goods, cosmetics and toilet articles, of other new goods in specialized stores, of second hand goods in stores and sale not in stores
6.4. Restaurants and Hotels – hotels, camping sites, restaurants, bars and cafes, catering

7. TRANSPORT, STORAGE AND COMMUNICATION SERVICES

7.1. Transport and Storage
7.2. Communication

8. FINANCING, INSURANCE, REAL ESTATE AND BUSINESS SERVICES

8.1. Financial Institutions
8.2. Insurance
8.3. Real Estate and business Services

9. COMMUNITY, SOCIAL AND PERSONAL SERVICES

9.1. Public Administration and Defense
9.2. Sanitary and Similar Services
9.3. Social and related Community Services – education services, research and scientific institutions, medical, dental and other health and veterinary services, welfare institutions, business professional and labour associations
9.4. Recreational and Cultural Services – motion picture and other entertainment, libraries, museums, botanic and zoological gardens, amusement and recreational services
9.5. Personal and House Services – repair services not elsewhere classified, laundries, laundry services, cleaning and dyeing plants, domestic services, miscellaneous personal services
9.6. International and Other Extra-territorial Bodies

0 ACTIVITIES NOT ADEQUATELY DEFINED
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